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IN THE

Supreme Court of the United States

October Term, 1973

No. 73-1652

YOUR HOST, INC., *et al.*,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

CHEF FOODS, INC., *et al.*,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners Your Host, Inc., Sher-Del Foods, Inc., 309 Delaware Ave., Inc., Alro Realty, Inc., Royal Host, Inc., Telesnax, Inc. and Main Host, Inc., pray that a writ or writs of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit in these cases.

Opinions Below

The opinion of the Tax Court (Appendix A, *infra* pp. 16-51) is reported at 58 T.C. 10. The opinion of the Court of Appeals (Appendix B, *infra* pp. 52-67) is reported at 489 F.2d 957.

Jurisdiction

The judgment of the Court of Appeals was entered on December 11, 1973. A petition for rehearing was denied and filed by the Court of Appeals on February 6, 1974. The jurisdiction of this Court is invoked under 28 USC 1254 (1).

Questions Presented

The questions presented are:

As to Your Host, Inc. and Chef Foods, Inc.

1. Whether the Commissioner of Internal Revenue may use § 482 to consolidate the income of two or more corporations formed for business reasons, having substantial income producing assets and conducting their own businesses?

2. Whether the authority granted by Congress to the Commissioner under § 482 to *"distribute, apportion or allocate"* the income or expense of corporations under common control includes the power to *"deny"* all but one of multiple surtax exemptions by the ruse of *"distributing, apportioning or allocating"* all of their income to one of them to be taxed with the benefit of only one surtax exemption.

As to Sher-Del Foods, Inc. and Your Host Bakery, Inc.

3. Same as No. 1. above.

4. Same as No. 2 above.

5. Whether the Court of Appeals was correct in sustaining a 100% allocation of income and refusing to remand the case to the Tax Court, even though it found that the only income or expense that could be said to have been arbitrarily shifted by management was a minor item—billing and delivery expense—the amount of which the taxpayer could readily prove if afforded the opportunity.

As to the § 269 Issues

May the Internal Revenue Service, without depriving the taxpayers of due process of law, reaudit the same facts 17 times over a span of 20 years with the conclusion that the corporations were not formed for tax avoidance purposes, and then, on the 18th audit, after the deaths of the men whose intent, purposes or mental processes are challenged, reverse itself and claim that their intent, purpose and motivation was tax avoidance?

Statutes and Regulations Involved

The relevant provisions of the Internal Revenue Code of 1954 and the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix D, *infra* pp. 70-75.

Statement

The Internal Revenue Service audited the tax returns of Alfred Durrenberger's corporations for the 18th time in 1967. In 17 prior audits going back to 1947, agents had found nothing to question about the corporate structure or the right of each corporation to its own income and expense.

In 1967 there were 36 restaurants operating under the name "Your Host" in Buffalo, Rochester and smaller communities in Western New York. They were owned, in varying numbers, by 11 restaurant corporations which had been formed during the years 1947 through 1955 for a number of sound and varied business reasons which had been scrutinized and approved in audit after audit from 1947 on. A 12th corporation operated a night-club requiring separate status to hold a liquor license.

Four other corporations, making 16 in all, performed different but essential functions. Sher-Del Foods, Inc., incorporated in 1947, was a commissary. It purchased meats and provisions from packing plants, growers and packers and sold processed and packaged foods to restaurants at wholesale. Your Host Bakery, Inc., incorporated in 1956, operated independently as a wholesale bakery of donuts, pastries and other sweet goods. 30% to 40% of their sales were to customers other than Your Host Restaurants.

Chef Foods, Inc., incorporated in 1958 too late to compete, as intended, in the in-plant feeding or catering business, was prospering as a cigarette vending machine company. The 16th corporation, Alro Realty, Inc., had been formed in 1951 as a real estate corporation to develop and operate a business block of stores and offices.

The Revenue Agents making the audit in 1967 could find no indication of any shifting of income or expense, omission of income, unreasonable deductions or any other evidence that the corporations' returns did not fairly and accurately reflect the income of each corporation or that the business relationships were anything other than arms-length.

Their sole concern was that the owner of these corporations had the benefit of too many surtax exemptions. So, they disallowed 14 of the 16 surtax exemptions on alternative grounds. First, they cited § 61 and § 482 as their authority to allocate the net income of 11 of the restaurant corporations and the cigarette vending machine company to the first corporation Durrenberger formed in 1947, namely Your Host, Inc. They explained that they were using § 61 and § 482 to disallow 13 of the 14 surtax exemptions: that, in this way, the consolidated income would be taxed to Your Host, Inc. at 48% with the benefit of only Your Host's surtax exemption. They then attributed the net income of Your Host Bakery, Inc. to Sher-Del Foods, Inc. under § 61 and § 482 for the same reason.

On the chance that it might not be proper to use § 61 and § 482 in this fashion to disallow surtax exemptions *indirectly*, they used § 269 and § 1551, in the alternative, to disallow the surtax exemptions *directly*. The disallowance was purely speculative, with no investigation of the historical facts.

At or before the trial they conceded that § 61 was inapplicable because these were not sham corporations and that § 1551 did not apply because no corporation was the transferee of the assets of any other corporation.

The Tax Court sustained their § 482 allocation only as to Chef Foods, Inc. (the allocation of the income of the cigarette vending machine company formed in 1958 to Your Host, Inc. formed in 1947) and Your Host Bakery, Inc. (the allocation of the net income of the bakery formed in 1956 to the commissary formed in 1947).

With respect to the § 269 issues, the Courts below found that 11 of the corporations had been formed for business reasons but that taxpayers had failed to overcome the presumption that five of them had been formed primarily to qualify for surtax exemptions. One had been incorporated in 1948 when there were no surtax exemptions, three in 1951 and the fifth in 1955. The Internal Revenue Service had actually explored the business reasons for the formation of four of them in 1955 and concluded they had been formed for business and not tax reasons. But, when the case was tried 20 years after the fact, the taxpayers were severely handicapped in their efforts to reconstruct the business facts of the post-war era and the motivation of businessmen under the 1939 Code. Both men, whose business motivation was at issue, were deceased, Ross T. Wesson in 1956 and Alfred J. Durrenberger in 1968.

The Second Circuit Court of Appeals affirmed the findings and rationale of the Tax Court. A dissenting opinion shows there was a fundamental disagreement over the right of the Internal Revenue Service to use the 100% allocation formula in dealing with separate, viable corporate entities.

Reasons for Granting the Writ

The reasons for granting the writ are as follows:

1. The decision below aggravates a state of confusion which has developed among the Circuit Courts and, in addition, creates a conflict within the Second Circuit itself, as shown by the answers given by them to the following questions:

(a) May the Commissioner, for tax purposes, use § 482 to consolidate the net income of corporations which were formed for sound business reasons and conduct their own businesses and tax the combined amount to one of them?

No	Third Circuit	C.I.R. v. Chelsea Products, Inc., 197 F.2d 620
No	Second Circuit	W. Braun Co., Inc. v. C.I.R., 396 F. 2d 264
No	Reg. Sec. 1.482-(b)(3)	The section is not intended to be used to get the equivalent of a consolidation of taxable income
Yes	Seventh Circuit	Wisconsin Big Boy Corp. v. C.I.R., 452 F.2d 137
Yes	Second Circuit	Your Host, Inc. v. C.I.R. (But see dissenting opinion)

(b) May the Commissioner allocate the net income of a group of controlled corporations to one of them in the absence of any evidence that the owner has shifted or distorted the income?

No	Second Circuit	W. Braun Co., Inc. v. C.I.R. (*supra*)
No	Tax Court	Bush Hog Mfg. Co., Inc. v. C.I.R., 42 T.C. 713
No	Third Circuit	C.I.R. v. Chelsea Products, Inc., (*supra*)
Yes	Seventh Circuit	Wisconsin Big Boy, Inc. (*supra*)

Yes	Second Circuit	Your Host, Inc. v. C.I.R. (But see dissenting opinion)
No	Reg. Sec. 1.482-1(b)(1)	Only if the owner has distorted the income
No	House Rep. No. 2, 70th Congress, 1st Session, p. 16	This section was designed to prevent the arbitrary shifting of profits from one corporation to another

(c) May the Commissioner use his power under § 482 to "distribute, apportion or allocate" gross income and deductions as a ploy to "deny" surtax exemptions?

No	Tax Court	The Challenger, Inc., 23 TCM 2096 (where the IRS explained that this was what it was doing)
Yes	Tax Court	Hamburger's York Road, Inc., 41 T.C. 821 (where the IRS did not disclose what it was doing)
No	Reg. Sec. 1.482-1(d)(2)	District Directors must make correlative adjustments of income and expense. (There is no correlative adjustment for the denial of a surtax exemption)[1]
No	Second Circuit	W. Braun Co., Inc. v. C.I.R. (*supra*)
Yes	Seventh Circuit	Wisconsin Big Boy Corp. v. C.I.R. (*supra*)
Yes	Second Circuit	Your Host, Inc. v. C.I.R. (*supra*)

(d) Should income be taxed to the person or entity which actually earns it?

Yes	Supreme Court	Moline Properties, Inc. v. C.I.R., 319 U.S. 436

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[1] The tax result is truly ridiculous. Your Host, Inc. is now paying the taxes of two corporations, while Chef Foods, Inc. has in excess of $35,000.00 of net income on which it pays nothing. Even the IRS is confused about how to handle it.

Yes	Supreme Court	National Carbide Corp. v. C.I.R., 436 U.S. 422
Yes	Second Circuit	W. Braun Co., Inc. v. C.I.R. (*supra*)
Yes	Second Circuit	Philipp Bros. Chemicals v. C.I.R. (*supra*)
No	Seventh Circuit	Wisconsin Big Boy Corp. v. C.I.R. (*supra*) The taxpayer must prove the Commissioner was completely unreasonable in allocating the income to a corporation that did not earn it
No	Second Circuit	Your Host, Inc. v. C.I.R. (*supra*) Where it was undisputed that Your Host did not earn it. It was taxed to Your Host, Inc. only because it was Durrenberger's first corporation

(e) Must a 100% allocation be sustained where the taxpayer proves that a lesser allocation is proper but fails to prove the exact amount? Should a remand to enable him to prove the exact amount be denied?

No	Supreme Court	Helvering v. Taylor, 293 U.S. 507
No	Fifth Circuit	Lufkin Foundry & Machine Co. v. C.I.R., 468 F.2d 805
No	Seventh Circuit	Baldwin-Lima-Hamilton Corp. v. U. S., 435 F.2d 182
Yes	Seventh Circuit	Wisconsin Big Boy Corp. v. U.S. (*supra*)
Yes	Second Circuit	Your Host, Inc.[2][3]

[2] It was undisputed that the only adjustment required to reflect the true income of Sher-Del Foods, Inc. and Your Host Bakery, Inc. was a charge to Your Host Bakery, Inc. for billing and delivery services performed by Sher-Del Foods, Inc. The Court below recognized this, but refused to remand the case to the trial court for a determination of the proper allocation. The dissenting judge would have remanded.

[3] Reg. Sec. 1.482-2 (b) (1) provides that where a controlled corporation performs marketing or other services for the benefit of another controlled corporation without charge, the District Director should make appropriate allocations to reflect an arms-length charge for such services. A 100% allocation is obviously not an arms-length charge.

ARGUMENT

As to the § 482 Issues

There is a fundamental conflict among the Circuits as to the boundaries of the Commissioner's authority to distribute, apportion or allocate gross income or deductions under § 482.

In *Chelsea Products* (*supra*) the Third Circuit said that both Treasury Regulations and the Committee Reports clearly delineate the scope of § 45 (now § 482); that the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arms length with an uncontrolled taxpayer, but that that it was "not intended to effect in any case . . . a result equivalent to a computation of consolidated net income under § 141."

The Third Circuit refused to allow the Commissioner to allocate all the net income of three corporations to a fourth, saying "There is no mention (in § 45) of authority to disregard completely the corporate entity by combining the net income of controlled corporations. The plain language of § 45 must prevail."

For a time other Circuit Courts reached the same conclusion. *W. Braun Co. v. C.I.R.* (*supra*) where the Court said "§ 482 does not give the Commissioner the power to disregard separate corporate entities if they are being used for a bona fide business purpose"; *Philipp Bros. Chemicals v. C.I.R.* (*supra*)

The Tax Court held that same view. *Bush Hog Manufacturing Co. v. C.I.R.*, 42 T.C. 713; *V. H. Monette v. C.I.R.*, 45 T.C. 15; *Dorba Homes, Inc. v. C.I.R.*, 26 T.C.M. 693.

However, in 1964, the Tax Court started the line of conflicting decisions with *Hamburger's York Road, Inc. v.*

C.I.R., 41 TC 821. The Internal Revenue Service sought to disallow the surtax exemption of Hamburger's York Road, Inc. under § 269 by claiming it had been created to get the benefit of a surtax exemption. In the alternative it consolidated its net income with that of Isaac Hamburger & Sons Co. under § 482. The Tax Court could have denied the surtax exemption under § 269. Instead, it taxed Isaac Hamburger & Sons on the combined income with one surtax exemption.

This § 482 approach to the disallowance of surtax exemptions was adopted by the Tax Court in *Marc's Big Boy-Prospect, Inc. v. C.I.R.*, 52 TC 1073 and its decision was affirmed by the Seventh Circuit Court of Appeals in *Wisconsin Big Boy Corp. v. C.I.R.*, 452 F.2d 137.

In both *Hamburger's York Road* and *Wisconsin Big Boy* there is no recognition of the fact that the Court, by requiring the equivalent of a consolidated return, was in fact disallowing surtax exemptions. But the deficiencies show that the amount of tax involved was the exact net difference between the tax computed with and without the benefit of surtax exemptions.

In the Your Host case there was abundant and undisputed proof that the Commissioner was deliberately consolidating the income of 14 of the corporations to Your Host, Inc. and Sher-Del Foods, Inc. solely for the purpose of disallowing their surtax exemptions and documentation showing that the deficiencies computed under § 482 were, to the penny, the same as from the denial of surtax exemptions under § 269.

The Supreme Court has had only one occasion (*Commissioner v. First Security Bank of Utah*, 405 U.S. 394) to rule on § 482 since the adoption of the Internal Revenue Code of

1954 and the emergence of § 482 as one of the most litigated corporate sections of the Code. Meanwhile, the lower Courts have been struggling with its provisions, inevitably arriving at conflicting and confusing conclusions.

The issue that has given them the most difficulty is the Commissioner's arbitrary use of the 100% allocation as an alternative to § 269 to disallow surtax exemptions and to transfer the burden of proof of the correct arms-length allocation to the taxpayer.

This case contains an abundance of clear-cut facts for a comprehensive analysis and determination of the scope and purpose of § 482 and the perimeters beyond which the Commissioner's use of it is arbitrary, unreasonable, unauthorized and unfair to the taxpayers.[4]

As to the Issue of Due Process

The taxpayers stoutly objected to being assigned the burden of proving Wesson and Durrenberger's intent, state of mind or motivation for forming corporations during the years 1948 through 1955, with both long since deceased and no one left to explain their business decisions except Durrenberger's widow and an office employee.

The Trial Court denied the taxpayers the right to present this evidence:

1. Audit reports showing that the IRS had audited Durrenberger's corporations 17 times from 1947 on, during

[4] For an independent confirmation of the fundamental conflict and confusion described above, see *Journal of Taxation*, Vol. 40, No. 4, April, 1974, page 222. It describes Your Host as a "startling contrast" to prior decisions of the Second Circuit and as showing how the Courts "by putting heavy procedural burdens on a taxpayer caught up in § 482 litigation" are letting the Internal Revenue Service use its 100% allocation of income approach to § 482 "behind a procedural smoke screen".

all the years the corporations were being formed and for over a decade thereafter, and had accepted their returns with minor adjustments.

2. Documentation of the audit in 1955 when, with the facts still fresh and Wesson and Durrenberger still alive, the IRS had explored all the circumstances surrounding the incorporation of 309 Delaware Avenue, Inc. in 1948 and Royal Host, Inc., Telesnax, Inc., and Alro Realty, Inc. in 1951 and agreed that they were not incorporated for tax avoidance purposes.

3. The revenue agent's report showing that he had raised the § 269 and § 1551 issues on pure speculation and without any inquiry into the facts and only because he got the idea from reading *Hamburger's York Road, Inc. v. C.I.R.* (*supra*) (Government Counsel conceded this, in effect, by saying that the § 269 issue had been raised to "protect the revenues").

The court imposed the burden on the taxpayers of proving that the Commissioner's determination was unreasonable, arbitrary and capricious. Yet, it deprived the taxpayers of the right to present the very evidence which would have demonstrated the unreasonableness of the Commissioner's sudden turnabout.[5]

Instead, the taxpayers had to call on Durrenberger's widow in an effort to explain and justify major business decisions he had made twenty years before. If she and the bookkeeper had died before trial, the taxpayers would have been totally defenseless.

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[5] The exclusion of evidence so essential to the taxpayers' burden of proof was a gross departure from "the accepted and usual course of judicial proceedings" within the meaning of Rule 19 of the Rules of the Supreme Court.

In short, the IRS was allowed an 18th audit of the same tax that had been present in 17 prior audits. For example, Wesson and Durrenberger incorporated Telesnax, Inc. in 1951 to allow a key employee to become a one-third owner as an added incentive to stay in their employ. Their purposes and objectives and the surrounding circumstances all relate to 1951. These business reasons became fixed in 1951 and never changed. They were fully explored in 1955 and the IRS agreed their intent was employee oriented and not tax avoidance.

It was not a fair hearing in 1971 when their survivors were deprived of the benefit of the facts that had been accepted by the IRS in 1955 and proof that the IRS had re-audited the same facts time after time from 1955 until 1967. It was not a fair hearing when the taxpayers had to reconstruct business reasons and intent best known to Wesson and Durrenberger and the realtors or landlords with whom they negotiated leases, all of whom were deceased or otherwise unavailable to testify.

Congress has said that separate corporations may be formed for legitimate business reasons such as those which motivated the incorporation of the petitioners without fear of attack under either § 269 or § 482. House of Representatives, Report Number 586, 82nd Congress, First Session, CB 1951-2, 506-507: Senate Report Number 830, 88th Congress, Second Session, CB 1964-1 (Part 2) 654.

Yet the effect of the decision below is that such corporations are subject to attack at the whim of any revenue agent, 20, 40, or even 50 years after the facts became fixed and unchangeable, no matter how many revenue agents had approved and reapproved their right to surtax exemptions and no matter how much of the evidence or the testimony has been forgotten, lost or destroyed because of deaths and the passage of time.

Conclusion

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: April 15, 1974.

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APPENDIX A

IN THE

UNITED STATES TAX COURT

YOUR HOST, INC., *et al.*,[1]

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket Nos. 2673-69, 2675-69—2688-69, 446-70, 448-70—461-70, 1194-71—1207-71.

Filed April 6, 1972.

Opinion

IRWIN, *Judge:*

Respondent determined the following deficiencies in the corporate income taxes of petitioners:

Petitioner	Docket No.	Year	Deficiency Sec. 482	Deficiency Sec. 531
Your Host, Inc.	2673-69	1965	$154,584.83	$93,040.86
		1966	173,381.44	98,958.31
	446-70	1967	170,930.11	94,399.00
	1194-71	1968	170,198.45	93,000.00
Alro Realty, Inc.	2675-69	1965	3,541.84	.....
		1966	2,791.52	.....
	461-70	1967	2,661.32	.....
	1207-71	1968	2,621.00	.....
Boulevard Host, Inc.	2676-69	1965	5,031.30	.....
		1966	5,000.08	.....
	448-70	1967	4,795.04	.....
	1197-71	1968	5,500.00	.....

[1] Listing of Tax Court docket numbers.

Appendix A

Petitioner	Docket No.	Year	Deficiency Sec. 482	Deficiency Sec. 531
Chef Foods, Inc.	2677-69	1965	5,000.04	.....
		1966	5,000.36	.....
	449-70	1967	4,999.96	.....
	1198-71	1968	5,500.00	.....
Main Host, Inc.	2678-69	1965	3,245.88	.....
		1966	4,999.40	.....
	450-70	1967	5,000.44	.....
	1199-71	1968	5,500.00	.....
Niagara Host, Inc.	2679-69	1965	5,000.08	.....
		1966	5,000.08	.....
	451-70	1967	4,999.84	.....
	1200-71	1968	5,500.00	.....
Rochester Host, Inc.	2680-69	1965	2,338.84	.....
		1966	489.56	.....
	452-70	1967	216.36	.....
Royal Host, Inc.	2681-69	1965	5,000.12	.....
		1966	5,000.76	.....
	453-70	1967	5,000.36	.....
	1201-71	1968	5,500.00	.....
Sharlem Host, Inc.	2682-69	1965	4,999.96	.....
		1966	5,000.36	.....
	454-70	1967	5,000.04	.....
	1202-71	1968	5,500.00	.....
Telesnax, Inc.	2683-69	1965	4,279.32	.....
		1966	4,904.76	.....
	455-70	1967	4,494.32	.....
	1203-71	1968	4,933.00	.....
309 Delaware Ave., Inc.	2684-69	1965	4,999.80	.....
		1966	5,000.32	.....
	456-70	1967	4,999.68	.....
	1206-71	1968	5,501.00	.....
Transit Host, Inc.	2685-69	1965	4,999.96	.....
		1966	5,000.16	.....
	457-70	1967	4,773.68	.....
	1205-71	1968	3,653.00	.....
Utica Host, Inc.	2686-69	1965	5,000.36	.....
		1966	4,690.48	.....
	458-70	1967	4,083.60	.....
	1204-71	1968	5,501.00	.....
Sher-Del Foods, Inc.	2687-69	1965	15,250.86	14,175.28
		1966	19,998.48	21,377.40
	459-70	1967	19,087.40	28,709.00
	1195-71	1968	21,509.43	18,115.00
Your Host Bakery, Inc.	2688-69	1965	5,000.08	.....
		1966	5,045.36	.....
	460-70	1967	5,000.20	.....
	1196-71	1968	5,500.00	.....

Appendix A

Respondent has conceded that petitioners Your Host, Inc., and Sher-Del Foods, Inc., are not subject to the accumulated-earnings tax imposed by section 531[2] for the years in question. After other concessions the following issues remain for decision:

(1) Whether respondent was arbitrary in allocating under section 482 all of the income and deductions of the 10 corporations operating restaurants and the vending machine corporation to Your Host, Inc.; and

(2) In the alternative to the first issue, whether the surtax exemptions provided by section 11(d) should be disallowed under section 269 in the cases of these corporations; and

(3) Whether respondent was arbitrary in allocating under section 482 all of the income and deductions of Your Host Bakery, Inc., to Sher-Del Foods, Inc.; and

(4) In the alternative to the third issue, whether the surtax exemptions of Your Host Bakery, Inc., and Alro Realty, Inc., should be disallowed under section 269; and

(5) Whether as an alternative to proceeding under section 269 the surtax exemption of Alro Realty, Inc., should be disallowed under section 1551.

We need not consider the second issue if the first issue is found in respondent's favor, nor the fourth issue if the third is found in respondent's favor. Similarly, there will be no deficiencies against the restaurant corporations if we uphold respondent on the first issue and no deficiency against Your Host Bakery, Inc., if we uphold respondent on the third issue.

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[2] All statutory references are to the Internal Revenue Code of 1954, as amended.

Appendix A

FINDINGS OF FACT

Some of the facts have been stipulated and they are so found. The exhibits attached to the stipulation are incorporated herein by this reference.

All of the petitioners herein are corporations chartered under the laws of the State of New York. For each of the years in question petitioners filed their Federal income tax returns with the district director of internal revenue, Buffalo, N.Y. During the years in issue the business address and principal place of business of petitioners was 3491 Delaware Avenue, Kenmore, N.Y.

The founders, principal stockholders, and officers of all of the corporations involved herein were Alfred J. Durrenberger, Jr. (Durrenberger), and Ross T. Wesson (Wesson). Wesson was killed in an airplane crash on July 17, 1956, and Durrenberger died on October 28, 1968. Wesson and Durrenberger will in some instances be referred to as the partners.

Before going into business together in 1944, Durrenberger had been a butcher and the owner of a retail meat market in the village of Kenmore, N.Y., and Wesson had run a diner in the village of Gowanda, N.Y. On May 1, 1944, Wesson and Durrenberger filed a certificate in the office of the Clerk of Erie County that they were conducting business under the assumed name and style of "Your Host," giving their business address as 461 Kenmore Avenue, Kenmore, N.Y., and thereupon proceeded to open a hot dog stand at that location. In 1946 they purchased the land on which the hot dog stand was located.

Appendix A

In December 1944, Wesson and Durrenberger leased property at 2835 Delaware Avenue, Kenmore, N.Y., next to Durrenberger's meat market, made leasehold improvements therein, and opened their first restaurant, known as Your Host Restaurant.

In 1945 Wesson and Durrenberger opened two more restaurants in the Buffalo area. These restaurants were all similar in appearance, operation, and menu and each operated under the name of Your Host Restaurant.

Your Host, Inc. (hereinafter Your Host), was incorporated and commenced business on January 1, 1947, with Durrenberger and Wesson as equal stockholders. They transferred to it the business assets and liabilities they had acquired as a partnership, including the leasehold improvements at the three restaurants and the hot dog stand, for promissory notes totaling $62,518.15 and 100 shares of the common stock of the par value of $100 per share.

On March 20, 1947, Wesson and Durrenberger purchased lots on Delaware Avenue in the town of Tonawanda, N.Y., (now known as 3491 Delaware Avenue), upon which was located a one-story cement block building intended to be used as a commissary. They thereupon incorporated Sher-Del Foods, Inc. (hereinafter Sher-Del), to operate a food-processing plant and commissary, and it commenced business on September 1, 1947. They transferred to it the property which they had bought at 3491 Delaware Avenue and other current and fixed assets for promissory notes totaling $43,400 and 100 shares of common stock of the par value of $100 per share. Sher-Del assumed Durrenberger's and Wesson's individual liabilities with respect to 3491 Delaware Avenue upon said transfer, and repaid the $43,400 promissory notes in the middle 1950's.

Appendix A

In 1947 Your Host opened two additional restaurants upon leased premises. These restaurants were similar in appearance, operation, and menu to the restaurants previously in business and each operated under the name of Your Host Restaurant.

On April 20, 1948, Wesson and Durrenberger, doing business as Your Host leased the premises at 309 Delaware Avenue, Buffalo, N.Y. The lease agreement required that the tenants operate a restaurant under the name of and in the manner of existing Your Host Restaurants. The lease further permitted the tenants to assign the lease to a corporation organized by them at which time their personal obligation for the rent would cease.

The prospects for a restaurant at 309 Delaware Avenue were not as favorable as those enjoyed at the other Your Host locations. The rent was higher there than for other locations ($250 to $300 per month over a 7-year period compared to a $200 maximum per month on a 10-year lease at 3232 Bailey Avenue). There were no adjacent parking facilities, and pedestrian traffic was not as heavy as at other locations. In light of these factors the attorney for Wesson, Durrenberger, and Your Host, F. Paul Norton (Norton), recommended that the restaurant at 309 Delaware Avenue be incorporated separately.

On June 9, 1948, Wesson and Durrenberger incorporated 309 Delaware Avenue, Inc. (hereafter 309 Delaware), as equal shareholders. Subsequently, 309 Delaware began operation of a Your Host Restaurant at 309 Delaware Avenue and became the assignee of the lease for those premises.

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During the period from 1951 to 1954 Wesson and Durrenberger caused three more corporations to be formed to operate Your Host Restaurants. These corporations were Royal Host, Inc. (Royal), Telesnax, Inc. (Telesnax), and Utica Host, Inc. (Utica). The circumstance surrounding their incorporation are summarized below:

1. *Telesnax.*—Wesson and Durrenberger set up Telesnax with two principal ideas in mind. First, they desired to give their accountant, James L. Clements, an opportunity to obtain a proprietary interest in the success of Your Host Restaurants. Second, they desired to take advantage of the burgeoning popularity of television by offering viewers an opportunity to order meals on the telephone that would be delivered to their homes. The name Telesnax was designed to convey this second purpose to the public, and by using Telesnax as a corporate name they felt that they could prevent its appropriation by another operation.

Clements did in fact obtain one-third of the stock of Telesnax; however, the meals-at-home idea was never developed and no attempt was made to obtain trademark protection for the Telesnax name. Instead of using Telesnax to develop the meals-at-home idea, Durrenberger felt it advisable to use the new corporation to operate a Your Host Restaurant in some empty store space next to a supermarket. This restaurant was opened for business in 1951.

2. *Royal Host.*—No particularly compelling reason was offered at trial for the formation of Royal Host in 1951 by Wesson and Durrenberger. Clements testified that there was concern that there would be infringement upon the

Your Host name by other businesses using a similar name. Consequently, the partners filed an application for incorporation under the name of The Host, Inc. This application was rejected because of its similarity to The Host, Incorporated, an already existing corporation. Incorporation of Royal Host and other corporations whose names included the word Host was seen as offering some protection for the Your Host business. The subsequent use of the Royal Host name by Wesson and Durrenberger is noted in the margin.[3]

Royal Host commenced operating a Your Host Restaurant in 1951 on leased premises.

3. *Utica Host.* Wesson and Durrenberger formed Utica Host in September 1954 to operate a Your Host Restaurant upon leased premises upon which a former tenant had operated a restaurant. This restaurant had failed and the landlord had become the owner of the restaurant assets. The former restaurant had a record of a small sales volume, was poorly designed, and was located in a "changing neighborhood." In light of these factors the partners decided the restaurant was a risky venture and should be separately incorporated.

[3] The Your Host Restaurants were very simple establishments emphasizing hamburger sandwiches on their menus. Wesson wanted to open up a fancy restaurant or steak house which served liquor. In 1954 Wesson and Durrenberger formed Air Host, Inc., as equal shareholders. Air Host commenced operating a restaurant of the type desired by Wesson called the Royal Host. Respondent has conceded the cases involving Air Host, Inc., and has not allocated the income and deductions of Air Host to Your Host. These concessions notwithstanding, Air Host will be mentioned in the opinion. It is important to remember that the Royal Host Restaurant was run by Air Host, Inc., and not by Royal Host, Inc., or one of the other "Host" petitioners.

Appendix A

Prior to 1953 all of the Your Host Restaurants except one were located in downtown commercial areas or in residential areas; however, in 1953 Wesson and Durrenberger became interested in placing restaurants in large suburban shopping plazas. At that time the development of large suburban shopping plazas was in its early stages. Norton recommended against placing Your Host Restaurants in the plazas because the shopping plaza idea was as yet untried in the Buffalo area, the plazas were not accessible to public transportation, and the onset of the Korean conflict made the availability of private automobiles and gasoline doubtful in his mind. In addition, placing restaurants in the plazas required a lease obligation of a longer term and for greater rent than Your Host had become accustomed to undertake. Because Wesson and Durrenberger felt that the plazas showed promise, Norton advised that each new restaurant be placed in a separate corporation in order to insulate Your Host in the event that the plazas did not live up to the partners' expectations.

During the period from 1953 to 1956 the following four corporations were organized to operate a Your Host Restaurant in a new shopping plaza:

Corporation name (abbreviation)	Shopping plaza	Date incorporated	Year plaza restaurant opened
Boulevard Host, Inc. (Boulevard)	Northtown Plaza	June 1953	1953
Niagara Host, Inc. (Niagara)	Marvin Gardens Plaza	February 1955	1955
Transit Host, Inc. (Transit)	Transitown Plaza	May 1955	1956
Sharlem Host, Inc. (Sharlem)	Sheridan-Harlem Plaza	June 1956	1957

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Boulevard, Niagara, and Sharlem were each incorporated with Wesson and Durrenberger as equal shareholders. Transit was a wholly owned subsidiary of Your Host upon its organization. In December 1955 Your Host acquired all of the stock of Niagara, and in February 1957 Your Host acquired all of the stock of Sharlem.

In addition to the above changes in the corporate family tree, Royal acquired all of the stock of Utica in December 1955.

In September 1955 Durrenberger became interested in a location for a Your Host Restaurant near the village of Williamsville. Durrenberger decided to set up a separate corporation to operate a restaurant on this location because he felt that his own resources and those of the other corporations had become overextended with the expansion of the Your Host chain into the shopping plazas. At this time Wesson was occupying himself primarily with running the Royal Host Steak House, fulfilling his duties as an officer in both the local and national restaurant associations, and flying his private airplane. There was no economic reason peculiar to the Williamsville location which indicated the need for a separate corporation.

In September 1955 Main Host, Inc. (Main), was organized by Wesson and Durrenberger and in January 1956 all of its stock was acquired by Royal. During 1956 Main commenced operating a Your Host Restaurant upon the Williamsville location.

In early 1956 Wesson and Durrenberger became interested in developing a chain of Your Host Restaurants in the area of Rochester, N.Y., which is about 70 miles dis-

tant. Two of their Buffalo area competitors had tried to penetrate the Rochester area previously without success. The partners anticipated problems stemming from the absentee management of the Rochester operations and were not confident of succeeding in the new area. Accordingly, they organized Rochester Host, Inc. (Rochester), in May 1956 as equal shareholders. After delays caused by the death of Wesson, Rochester opened its first Your Host Restaurant in the Rochester area in the latter part of 1957.

Rochester was the last corporation formed by the partners to operate Your Host Restaurants; however, new restaurants were added to the chain without creating any additional corporation. The following chart indicates the development of the Your Host restaurant chain from 1944 to 1969 by showing the names of the corporations and the years in which each first opened a restaurant as well as the latter years in which each corporation opened additional restaurants:

YEARS IN WHICH RESTAURANTS WERE OPENED

Corporation	1st	2d	3d	4th	5th	6th	7th	8th	9th	10th thru 15th
Your Host	1944	1944	1945	1945	1947	1947	1958	1959	1960	1969
309 Delaware	1948	1949	1950	1959						
Royal	1951									
Boulevard	1953	1966								
Utica	1954	1958	1964	1968						
Niagara	1955	1960	1964	1965						
Main	1956	1959	1966							
Transit	1956	1960								
Sharlem	1957	1960	1963							
Rochester	1957	[1]1962	[1]1952							
Telesnax	1951	[2]1968								

[1] Terminated business in 1968.

[2] Replaced first restaurant.

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The capital needed for the expansion of the Your Host Restaurant chain came primarily from three sources: (1) Relatively small capital contributions from either the partners or one of the corporations; (2) substantial open-account interest-free cash loans from Your Host, Sher-Del Foods, or one of the other restaurant corporations; and (3) credit from Sher-Del for supplies used during the first few weeks of a new restaurant's business.

In all cases the corporations were only responsible for the rent payments on the premises on which they actually operated restaurants. In any case in which Wesson and Durrenberger, Your Host, or one of the restaurant corporations negotiated a lease for a new restaurant location the lease contained provisions permitting its transfer to another corporation without any liability on the part of the initial lessee. Apparently the lease between Wesson and Durrenberger and the landlord of 309 Delaware Avenue entered into in 1948 served as a model for all subsequent leases for Your Host Restaurants.

In 1947 Wesson and Durrenberger incorporated Sher-Del Foods, Inc., to operate a food-processing plant and commissary. The Your Host Restaurants were only able to buy meat and other supplies at retail prices: therefore, it was necessary to establish Sher-Del as a bona fide independent food wholesaler so that it could take advantage of the wholesale prices available to such concerns. The Your Host Restaurants buy all of their supplies from Sher-Del on an open-account basis: however, 30 percent of Sher-Del's business on the average is with outside customers. The prices charged Your Host Restaurants and outsiders are the same.

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Initially Sher-Del operated the commissary business in one-story building located at 3491 Delaware Avenue, Tonawanda, N.Y. Wesson and Durrenberger had purchased this building and nine lots at this address in 1947 and contributed them to Sher-Del. In 1948 and 1949 Sher-Del bought four lots adjoining the commissary, began to develop the property as a business block, and added storefront space. In 1950 Sher-Del improved and enlarged its commissary operation upon this property, and in August 1951 Royal commenced operating a Your Host Restaurant in the storefront space.

On October 1, 1951, Sher-Del sold this property to a new corporation formed by Wesson and Durrenberger, Alro Realty, Inc. (Alro), for $112,822.93 represented by a 4-percent promissory note.

Alro Realty, Inc., was formed in September 1951 with Wesson and Durrenberger as equal shareholders. The partners believed that they could obtain better mortgage financing if one corporation owned all of the real estate that at that time was owned by Your Host and Sher-Del. They also hoped to infuse some cash into Sher-Del when Alro paid the $112,822.93 note with which it purchased 3491 Delaware Avenue and adjacent land from Sher-Del. In fact, Alro was never particularly profitable and did not reduce the unpaid balance of the note below $110,000; however, Alro did purchase additional land adjacent to 3491 Delaware Avenue until it had acquired an entire city block. Upon this block it developed a small plaza which housed the business offices of all of the related corporations and provided space for unrelated tenants.

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In 1955 the partners were presented with an opportunity to purchase a fully equipped bakery for an investment of $15,000 in cash and a mortgage of $18,000. Not only was the purchase price of the bakery favorable, but also the acquisition protected the restaurants from a loss of local supplies of sweet baked goods. A significant portion of the business of the Your Host Restaurants came from the sale of pies, cakes, doughnuts, and other sweet goods, and this business would suffer if an adequate supply of sweet goods could not be maintained.

Although the bakery would have assured purchasers for its products in the Your Host Restaurants, the partners felt that their inexperience in the baking business made the success of the bakery somewhat doubtful and that it would be best to limit the liability of the other businesses to the $15,000 cash investment. Accordingly, Your Host Bakery, Inc. (Bakery), was formed in November 1955 with Wesson and Durrenberger as equal shareholders to operate the bakery.

Bakery was a successful venture. It did not sell any of its products directly to the public or to the restaurants. Sher-Del took orders for baked goods from the restaurants and made purchases from Bakery. The prices which Sher-Del paid Bakery for baked goods and which the restaurants paid Sher-Del for the same items were identical and were based upon the wholesale pricelist of a commercial baking corporation.

Chef Foods, Inc. (Chef), was the last corporation to be formed. In 1956 Wesson and Durrenberger began exploring the idea of providing meal-catering service

in industrial plants. The death of Wesson in 1956 and the expansion of the restaurant business caused Durrenberger to defer the development of the in-plant feeding idea. In 1958 he formed Chef Foods, Inc., to go into the in-plant feeding business; however, this business was never developed. Instead, Chef purchased vending machines in 1959 and 1962. These machines were placed only in Your Host Restaurants. In addition, Chef purchased refrigeration and storage plants located at 2646 Delaware Avenue in 1959. Sher-Del leased from Chef a part of these facilities for use in the commissary business and Chef used the other part for the vending business.

The Your Host Restaurants were all similar in appearance, served identical menus at the same prices, and were open for business 24 hours a day. In their advertising the restaurants tried to convey to the public that each restaurant was a part of a chain with the same management. No attempt was made to convey to the public the separate corporation ownership of some of the restaurants. Solicitations in the newspapers for employees were made in the name of Your Host Restaurants, and letters were sent under the cover "Your Host and Family Restaurants" even though they were signed in the name of individual corporations.

The president of each corporation was Durrenberger from Wesson's death in 1956 until his own death in 1968. Following her husband's death, Durrenberger's widow became the president of each corporation. As will be explained *infra*, the restaurants shared the same top management personnel. None of the corporations paid Your Host for use of the Your Host trademark.

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Each of the corporations maintained its own minute book; however, the minutes recorded for Your Host were meager while those recorded for the other corporations were nearly nonexistent. Each corporation had at least one bank account, and each restaurant maintained a depository account at a bank situated near to it. Deposits representing daily receipts of each restaurant were placed in the respective depository accounts and then transferred on weekly basis to the bank account of the corporation to which they belonged. Each corporation used its own bank account to pay most of the expenses attributable to the operation of its restaurants. These expenses included supplies purchased from Sher-Del, utility bills, rent, Federal and State income taxes, social security taxes and income taxes withheld from employees, fire insurance, license fees, and sign bonds (where necessary).

Because Your Host could obtain master policies for public liability insurance and workmen's compensation covering all the restaurants and their employees for a cost that was less than the combined cost of separate policies for each corporation, Your Host advanced the premium payment to obtain such master policies. Your Host was then reimbursed by the other corporations for their share of the premium, which was computed by the insurer or it agent according to a formula based upon the payroll of each corporation.

At one time the corporations paid the wages for their employees in cash; however, in 1952 wages began to be paid by check for security reasons. For administrative convenience and to enable the employees to cash their

checks without difficulty, salaries for all employees of every corporation were paid from a special zero-balance payroll account maintained by Your Host. This account worked in the following manner: Every week each corporation computed its own net payroll (after deduction for withholding items) and paid this amount into the "Your Host, Inc., Payroll Account"; all wages were then paid from this account leaving a "Zero balance." This payroll account was not carried as an asset upon the books of Your Host.

Each restaurant had its own manager who was generally responsible for the operation of his restaurant. His duties included ordering supplies and hiring and firing employees; however, the manager had no authority to change the menu of the restaurant, change its business hours, or purchase supplies from someone other than Sher-Del. The restaurant managers could not write checks. The managers were compensated on a salary-plus-bonus arrangement. The amount of the manager's bonus depended upon the success of his location.

The personnel needed to administer and maintain all 16 corporations were nominally the employees of Your Host; however, the expenses attributable to these employees were in fact shared by all of the corporations during the years in issue in the following manner:

(1) With exceptions noted below, the cost of the administrative staff (bookkeepers, typists, clerks, and the like), group insurance premiums, and the expenses of the administrative office were allocated among the corporations according to gross sales;

(2) Advertising costs were allocated among the corporations operating Your Host Restaurants in the Buffalo area according to gross sales;

(3) The cost of the maintenance crew and the salaries of the Your Host Restaurant area supervisors—six or seven men who each oversaw the operations of six or seven restaurants—were allocated among the corporations operating Your Host Restaurants.

The gross sales of Air Host which operated the Royal Host Restaurant were included in the administrative expense allocation at only half of actual sales excluding liquor sales. This adjustment was made to reflect the fact that the Royal Host Restaurant sold liquor and meals which were considerably more expensive than those available in Your Host outlets. The high price of Royal Host meals did not command a proportionately high amount of administrative effort.

The gross sales of Sher-Del were included in the administrative expense allocation at a figure that was less than actual sales to reflect the fact that intercorporate sales did not require a great deal of administrative effort and that Sher-Del employed a small administrative staff of its own. The figure used for gross sales was either one-half actual sales or twice sales to unrelated customers.

Rochester Host was not included in the advertising expense allocation because the Rochester restaurant could not benefit from Buffalo area advertising. It appears from the record that Your Host paid more than its share for advertising under the formula. No explanation can be found

for the discrepancy except that Your Host may have paid entirely on its own for certain small advertising items like help-wanted ads.

The corporations not running restaurants and Air Host were allocated no part of the advertising or area supervisor expenses because these items related particularly to the sales of the Your Host Restaurants.

Although Your Host advanced the funds necessary to take care of the administrative, advertising, and supervisory expenses, each of the corporations did in fact pay its allocated share of the expenses. Only the allocable part of the expenses appear on the returns of each corporation.

In all of the years in issue Durrenberger drew part of his salary from each of the corporations. The following chart represents his draw from each corporation:

	1965	1966	1967	1968
Shel-Del Foods, Inc.	$22,500	$22,500	$22,500	$18,750
Your Host, Inc.	12,600	12,600	11,400	11,400
309 Delaware Ave., Inc.	7,800	5,400	4,200	1,500
Royal Host, Inc.	1,500	1,000	1,000	833
Telesnax, Inc.	1,000	1,000	1,000	833
Boulevard Host, Inc.	1,000	1,000	1,000	1,000
Air Host, Inc.	1,100	1,000	1,000	833
Utica Host, Inc.	1,100	1,500	2,000	1,667
Niagara Host, Inc.	1,100	2,000	4,000	3,333
Main Host, Inc.	1,100	1,200	2,000	1,667
Transit Host, Inc.	1,100	1,200	1,200	1,333
Sharlem Host, Inc.	1,100	1,500	2,000	1,667
Rochester Host, Inc.	1,100	1,500	2,200	833
Your Host Bakery, Inc.	1,000	1,500	1,500	1,333
Alro Realty, Inc.	1,000	1,000	1,000	833
Chef Foods, Inc.	1,000	1,500	1,500	1,333
Total	57,100	57,400	58,500	49,148

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The 15 corporations reported the following amounts of taxable income for the years in issue:

	1965	1966	1967	1968
Your Host	$136,702	$107,101	$126,338	$111,310
309 Delaware	47,960	45,859	48,816	38,820
Royal	31,894	35,587	33,107	39,142
Boulevard	25,932	28,596	23,973	27,822
Utica	28,132	23,451	20,420	25,674
Niagara	36,646	58,971	71,358	58,031
Main	16,231	35,680	38,153	50,392
Transit	38,402	36,092	23,866	16,602
Sharlem	29,695	29,607	36,748	30,273
Rochester	11,693	2,447	1,082	(Loss)
Chef	31,098	42,882	41,727	35,760
Telesnax	16,459	18,737	17,284	17,253
Bakery	34,896	44,882	43,390	43,327
Sher-Del	41,212	79,494	158,231	64,816
Alro	17,708	13,799	13,309	11,908

OPINION

In 1944 Wesson and Durrenberger opened the Your Host hot dog stand in Buffalo as a partnership. In the same year they commenced operating the first Your Host Restaurant, a high-quality short-order restaurant. Two more Your Host Restaurants were opened in 1945. In 1947 Your Host, Inc., was formed by the partners to operate their hot dog stand and the three restaurants. In 1947 the partners formed Sher-Del to operate a commissary which would supply their restaurants and other customers. Between 1948 and 1956 10 more corporations were formed for various reasons (or for no apparent reason at all) to operate additional Your Host Restaurants. In 1951 the partners placed all of the real estate holdings of Your Host and Sher-Del into a new corporation, Alro, in order to develop these holdings commercially. In 1955 the partners formed Bakery to operate a bakery which would supply the restaurants

with their needs for sweet baked goods. In 1958 Chef was formed to operate vending machines in Your Host Restaurants. No additional corporations were formed after 1958; however, the size of the restaurant chain grew considerably. In 1969 there were 40 Your Host Restaurants of which Your Host operated 15 with each of the 10 other restaurant corporations operating four or fewer locations.

After Wesson's death in 1956 all of the corporations except one were either wholly owned by Durrenberger or wholly subsidiaries of one of Durrenberger's corporations. Durrenberger was the president of each corporation, and all the corporations shared the same administrative personnel. All of the Your Host Restaurants operated by 11 corporations were similar in appearance, served the same menu, and were open for business 24 hours a day. Through advertising and telephone directory listings the public was given the impression that each Your Host Restaurant was a member of a chain with a single management.

Respondents allocated all of the income and deductions of the 10 corporations operating restaurants and the vending machine corporation to Your Host and the income and deductions of Bakery to Sher-Del. In the alternative, respondent has disallowed the surtax exemptions of every corporation except Your Host and Sher-Del under either section 269 or section 1551. We are to decide whether respondent's determinations are correct.

The facts of this case have many similarities to those of *Marc's Big Boy-Prospect, Inc.*, 52 T.C. 1073 (1969), affd. 452 F. 2d 137 (C.A. 7, 1971), under which respondent believes his allocations under section 482 can be supported without question. If the present case were the mirror image

of *Marc's Big Boy-Prospect, Inc.*—which it is in respondent's view—our task would be much simpler than we now foresee; however, in our view there are several facts which distinguish this case from *Marc's Big Boy-Prospect, Inc.*, and which require a result unlike that of the former case. Accordingly, we shall try to place this case within the proper prospective of section 482 and the pertinent cases which deal with section 482.

Section 482 permits the Secretary or his delegate to allocate income and deductions among two or more organizations owned or controlled by the same interests if he determines that such allocation is necessary to prevent evasion of taxes or clearly to reflect the income of such organization. The Commissioner's authority to allocate, though broad, does not permit him to abuse his discretion or be arbitrary, capricious, or unreasonable. The burden is, however, upon petitioner to show that the Commissioner has overstepped his authority. *Marc's Big Boy-Prospect, Inc., supra; Bush Hog Manufacturing Co.*, 42 T.C. 713 (1964). See particularly *Phillip Brothers Chemicals, Inc. (N.Y.) v. Commissioner*, 435 F. 2d 53 (C.A. 2, 1970), which arises in the circuit in which appeal herein would lie. Despite petitioner's burden, if the Commissioner's allegation does not appear reasonable in light of the record, we must conclude that he abused his discretion. *V. H. Monette & Co.*, 45 T.C. 15, 36-37 (1965).

The parties have approached section 482 as if it dealt with several types of prohibited activity; however, our review of the statute and its legislative and judicial history indicates that section 482 is designed to remedy only one abuse: the shifting of income from one commonly controlled entity to another. *Hamburgers York Road, Inc.*, 41 T.C.

821, 833 (1964); *Ballentine Motor Co. v. Commissioner*, 321 F. 2d 796 (C.A. 4, 1963), affirming 39 T.C. 348 (1962); H. Rept. No. 2, 70th Cong., 1st Sess., pp. 16-17, 1939 C.B. (Part 2) 395. Tax-avoidance motives or the lack of a business purpose in forming several corporations are relevant in a section 482 case only to the extent that they prove that there has been an actual shifting of income from one corporation to another. Section 482 is not designed to punish the mere existence of commonly controlled entities nor the unexcised power to shift income among them. *Grenada Industries, Inc.*, 17 T.C. 231 (1951), affd. 202 F. 2d 873 (C.A. 5, 1953); *Bush Hog Manufacturing Co., supra* at 725; *W. Braun Co. v. Commissioner*, 396 F. 2d 264 (C.A. 2, 1968). Similarly, if there has been an actual shifting of income, purity of purpose and the presence of sound business reasons for forming multiple corporations are no defense under section 482. In short, section 482 does not deal with motivation and purpose as do section 269 and section 1151 but with economic reality.

Many section 482 cases involve a specific transaction or group of transactions which must be scrutinized for their effect in shifting income from one entity to another; however, it is well settled that the Commissioner can use section 482 to allocate all of the income and deductions of one entity to another where the economic realities so warrant. *Hamburgers York Road, Inc., supra; Marc's Big Boy-Prospect, Inc., supra.*

In *Hamburgers York Road, Inc.*, a successful downtown department store decided to establish a suburban branch store; however, instead of operating the store as a branch the suburban store was incorporated with its ownership related to that of the corporation operating the downtown

store. On the record in that case we found that the downtown store provided without adequate compensation so many services for the suburban store that were essential to the suburban store's economic viability that the income of the suburban store was in fact earned by the downtown store. 41 T.C. at 835-838.

As we noted previously, the facts in *Marc's Big Boy-Prospect, Inc.*, resemble those of the present case in many ways. In the former case, Wisconsin Big Boy (WBB) acquired the Big Boy restaurant franchise for the State of Wisconsin. Within a few years it set up or acquired from its shareholders several subsidiary corporations to operate restaurants in the Milwaukee area and two corporations to run commissaries. Each of the subsidiaries operated a restaurant under a subfranchise agreement with WBB. The agreement provided that WBB could supply each subfranchise with supervisory and management services for a modest sliding-scale percentage-of-profits fee. The subfranchisees also received the right to use the national Big Boy trademark under the agreement. Under the arrangement, WBB was responsible for running the whole restaurant chain. Accordingly, we found that WBB and the Milwaukee area subfranchisees constituted a single integrated business enterprise. This fact along with the fact that there was no economic reason for setting up multiple corporations created a strong inference that the subsidiary corporations were used to syphon off to the subsidiaries income which was earned by WBB. 52 T.C. at 1099. More importantly, WBB was unable to show that the fees that it received from its subsidiaries represented adequate compensation for the services that it rendered the subsidiaries. On these grounds, we hold that respondent was not unrea-

sonable in allocating all of the income and deductions of the subsidiaries to WBB.

A large part of our opinion in *Marc's Big Boy* was devoted to detailing the integration of the Milwaukee area Big Boy restaurants as a single business enterprise; however, we believed that it was clear that we were not using section 482 to penalize the petitioners merely for operating a single business through several corporations but to reflect the fact that subsidiaries were being used to distort the amount of income reported by WBB. The operation of a single business through several corporations creates a likelihood that subsidiaries will be used either to permit the parent to evade taxes or to understate its income. We believed that without evidence that the parent and its subsidiaries dealt at arm's length with each other this liklihood formed a reasonable basis for the Commissioner's allocation under section 482. 52 T.C. at 1099. Accordingly, the allocation to WBB was sustained not because there was an integrated business but because there was no proof that WBB and its subsidiaries dealt at arm's length.

With differences that we shall discuss *infra*, the Your Host Restaurants constituted as much of a single integrated business enterprise as did the Milwaukee area Big Boy chain; however, approval of respondent's allocation under section 482 is not ineluctable.

We note that in several respects the restaurant corporations in this case were more viable economically than were the restaurant subsidiaries in *Marc's Big Boy*. All of the corporations paid directly most of their own costs of doing business. These costs included supplies purchased from Sher-Del, utility bills, Federal and State income taxes,

social security taxes and income taxes withheld from employees, fire insurance, and license fees. More importantly, each corporation paid the rent for the locations on which it operated restaurants and was solely responsible for it. Your Host did not guarantee payment of the rent for any locations except its own, and landlords were apparently willing to rely upon the financial responsibility and resources of each corporation rather than those of the total enterprise.

We are also convinced that the fact that Your Host obtained master policies for public liability insurance and workmen's compensation for reasons of economy and administrative convenience does not detract from the fact that each corporation paid its appropriate share of the cost of these items. We think that the situation of Your Host with respect to these expenses is different from that of WBB in *Marc's Big Boy*. WBB operated no restaurants of its own and its only activities were related to running the restaurants owned by its subsidiaries. Hence, it would be impossible to distinguish between WBB's obtaining insurance for its subsidiaries and its providing every other management service for them. On the other hand, Your Host operated as many as 15 restaurants of its own. It incurred no expense in obtaining insurance for the other corporations and benefited from the reduced rates which were available when a larger number of restaurants were insured on the same policy.

Each of the corporations in effect paid the salaries for its own nonadministrative employees. Your Host did no more than lend its name to the "Zero balance" account from which these employees were paid. Your Host did not advance its own funds to pay salaries from this account but only

contributed the net salary of its own employees as did the other corporations. The service charges by the bank for the "Zero balance" account were apportioned among the corporations along with other administrative expenses.

The main point of contention between the parties is whether the 15 corporations shared the same administrative staff and maintenance crew or whether Your Host provided for a fee administrative and maintenance services. Under either theory respondent contends that the amounts paid by corporations for these services were computed under an arbitrary and ever-changing formula. We think it immaterial that the corporations may have used a different formula in other years because those years are not before us. During the years before us the cost of providing administrative and maintenance services for all corporations was generally apportioned according to gross sales. Respondent did not determine that this method was unreasonable and we believe it to be based reasonably upon economic realities. We also find it reasonable that advertising expenses and the costs attributable to the district supervisors and maintenance men were only apportioned among the corporations which could benefit from these expenditures. In fact, to have apportioned otherwise would have distorted the income of the nonbenefiting corporations.

The only deviations from the allocation based on gross sales involving a corporation whose case is before us are an adjustment for Sher-Del and the apportionment of the salary paid Durrenberger. The accountant for all of the corporations testified that sales between Sher-Del and its sister corporations did not involve as much administrative effort as did sales to outside customers. Accordingly, he felt that it was necessary to reduce the amount of Sher-Del's

gross sales for purposes of making the administrative expense allocation. From his testimony and other evidence in the record we find that the adjustments made were reasonable.

Durrenberger received about 40 percent of his total salary from Sher-Del, a fact which is explained by his background and expertise in the provisions business. The remainder of his salary was contributed by the other corporations. In the case of the restaurant corporations the amount paid appears roughly to reflect the business activity and number of restaurants of each corporation.

In our opinion petitioners have demonstrated that each corporation paid its own way and that they were economically viable business entities. We are convinced that except for *de minimis* items like help-wanted ads Your Host bore no more of the administrative burden for the restaurant chain than could be accounted for by its own sales. Your Host provided no service for the other corporations for which it was not adequately compensated. Accordingly, unless Your Host could have commanded all of the profits of the other restaurant corporations for the use of its trademark and goodwill, we believe that respondent's allocation is unreasonable for failing to allocate any part of the profits to the corporations which earned them through their own efforts and expense. We emphasize again that the purpose of section 482 is not to punish the existence of multiple corporations but to require each corporation to report its true income.

The trademark and goodwill possessed by Your Host differ considerably from those of WBB in *Marc's Big Boy* and of the downtown store corporation in *Hamburgers York*

Road, Inc. First, the restaurants operated by Your Host were on the average no older or more well established than those operated by the 10 other restaurant corporations. The restaurants operated by the 10 other corporations did not trade upon goodwill generated by the restaurants run by Your Host; all of the restaurants generated goodwill which was shared by all of them equally. The public did not associate a particular restaurant with the corporation that operated it, and it makes as much sense to assume that the 10 restaurant corporations donated goodwill to Your Host as it does to assume that Your Host donated goodwill to the other 10. Therefore, the situation is obviously different from that which obtained in *Hamburgers York Road, Inc.*, where the success of the suburban store depended largely upon the public's belief that it was a branch of the old and respected downtown store. Second, we believe that the Your Host trademark had little value in addition to the goodwill generated from the operation of the restaurants themselves. The Your Host trademark cannot be compared to the Big Boy trademark in Marc's Big Boy which was used nationally and which permitted the Milwaukee area restaurants to benefit from the goodwill generated by others across the country. Although Your Host owned the trademark, the concept of Your Host Restaurants really belonged to Wesson and Durrenberger who could donate their idea to their corporations. Without doubt there was an advantage to being a Your Host Restaurant rather than another short-order cafe; however, we feel that this advantage flowed primarily from the local advertising and management shared by all of the corporations. We have already determined that the corporations divided up these items equitably. The near failure of the Rochester Your Host Restaurants, which had absentee management problems, indicated

that without the concentrated local advertising and local management the Your Host name was not worth a great deal.

We hold in light of the record in this case that the 10 restaurant corporations were viable economic entities which earned their own income and that Your Host provided no service or benefit to these 10 corporations for which it was not adequately compensated. Accordingly, we hold that respondent may not allocate to Your Host, Inc., all of the income and deductions of the 10 restaurant corporations for the years in issue.[4]

While we believe that the 10 restaurant corporations were economically viable, this opinion does not hold true in the cases of Chef, the vending machine corporation, and Bakery.

All of Chef's income was derived from renting refrigeration and storage facilities to Sher-Del and from operating vending machines which were located solely in Your Host Restaurants. There is nothing in the record which indicates whether the terms upon which Chef dealt with its parent, Sher-Del, or its sister corporations were fair and reasonable. Chef, in substance, conducted no business; therefore, it was reasonable for respondent to determine that it did not earn its income. Accordingly, we hold that respondent did not abuse his discretion in allocating all of

[4] The parties have proceeded upon an all-or-nothing approach with respect to sec. 482. A partial allocation under sec. 482 was not among the several alternative resolutions of this case presented by the parties. Accordingly, we do not think that a partial allocation, the basis of which is not readily apparent from record, would be appropriate in this case. *Cf. Marc's Big Boy-Prospect, Inc.*, 52 T.C. 1073 at 1105-1106; *Helvering v. Taylor*, 293 U.S. 507 (1935).

Chef's income and deductions to Your Host under section 482.

We view the operations of Bakery in a similar light. Bakery only sold its products to Sher-Del; it could hardly be considered to have conducted any business. In addition, Sher-Del paid Bakery the same prices for its products as Sher-Del charged the restaurants. This arrangement garnered for Bakery all of the profit from the manufacture and sale of baked goods. We believe that respondent proceeded upon a reasonable basis in allocating all of Bakery's income and deductions to Sher-Del under section 482 and uphold his determination.

Although we have found that the 10 restaurant corporations earned their own income and reported it correctly for purposes of section 482, it does not follow that every one of this host of corporations is entitled to the surtax exemption provided by section 11(d). Respondent contends that the principal purpose for forming the 10 restaurant corporations was to obtain additional surtax exemptions and that section 269(a) is applicable to disallow these benefits. We agree with respondent with respect to 309 Delaware, Royal, Main, Telesnax, and Alro only.

Section 269 provides the following in part:

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) IN GENERAL.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

> (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transfer corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

It is well established that the formation of a new corporation is an acquisition for purposes of section 269. *James Realty Co. v. United States,* 280 F. 2d 394 (C.A. 8, 1960). We have also held that section 269 applies to an acquired corporation as well as an acquiring corporation. *Concord Supply Corporation,* 37 T.C. 919 (1962). On the facts in this case there is no dispute that the requisite control is present. Accordingly, the only question remaining under section 269 is whether the corporations were formed for tax-avoidance purposes.

Respondent has pointed to several facts as ruling out all non-tax-avoidance purposes for forming the 10 corporations. These facts include the integration of the 10 corporations into a single business, the thin capitalization of the corporations, and the frequent interest-free loans and

advances among the corporations which were not evidenced by notes. In addition, respondent finds no business reason in his view of the record which justifies the existence of more than one corporation. *Concord Supply Corporation, supra; Joe (Joseph) Dillier*, 41 T.C. 762 (1964), affirmed *sub nom. Made Rite Investment Co. v. Commissioner*, 357 F. 2d 647 (C.A. 9, 1966). Petitioner, on the other hand, has attempted to show the economic reasons underlying the formation of each corporation. *Southeastern Canteen Co. v. Commissioner*, 410 F. 2d 615 (C.A. 6, 1969), certiorari denied 396 U.S. 833 (1969).

We believe that the facts noted by respondent are strong circumstantial evidence that tax avoidance was a principal purpose in the formation of the 10 corporations. We also tend to discount petitioners claim that the corporations were set up solely on the advice of their attorney who was an expert in real estate matters without any knowledge of taxation. The benefit of multiple surtax exemptions is, we believe, as obvious to a layman as it is to a tax expert.

Throughout the trial and on brief petitioners have complained that their burden of proof under section 269 is impossible because the corporations were formed from 13 to 22 years before trial and because the principals involved in developing the Your Host Restaurant chain were either dead or unavailable for trial. We sympathize with petitioners and have allowed them great latitude in submitting evidence concerning the formation of the restaurant corporations. We also note that respondent's ability to rebut evidence of purpose has not improved with the passage of time. More importantly, the existence of a principal non-tax-avoidance purpose for forming the corporations can

better be proven with evidence of objective facts rather than with subjective evidence of intent provided by the principals. *Bobsee Corporation v. United States*, 411 F. 2d 231 (C.A. 5, 1969). Petitioners have brought forth such evidence in the cases of Boulevard, Niagara, Transit, and Sharlem (the shopping plaza corporations) and in the cases of Utica and Rochester.

We believe that the risks involved in the mid-1950's in opening up restaurants in the emerging new suburban shopping plazas on long-term leases justified the formation of separate corporations. The chance of failure in these locations was substantial and formed the principal motivation for the formation of Boulevard, Niagara, Transit, and Sharlem. The first of these corporations, Boulevard, was formed in 1953 and the last, Sharlem, in 1956 before it became apparent that the shopping plazas were desirable locations. We must lend credence to petitioners' contention that the riskiness of being a pioneer in shopping plaza development was the primary purpose for the formation of the four corporations because following the success of the first plaza locations additional plaza locations were opened without the use of additional corporations.

Utica was formed in 1954 to operate a restaurant in a location upon which a former restaurant proprietor had failed. The restaurant was also in a neighborhood which the partners felt was incompatible with the kind of people who patronized Your Host Restaurants. We believe that the previous record of failure and the problems in the neighborhood in which the restaurant was to be located were the principle factors which motivated the partners to form Utica.

Appendix A

Rochester was incorporated in 1956 to begin developing a chain of Your Host Restaurants in the Rochester area. The problems involved in operating restaurants 70 miles distant from Your Host's normal base of operations were in our opinion substantial. The partner's principal purpose in forming Rochester was to protect their enterprise from the significant risk of losses from the Rochester operation. The partners' fears about the potential for failure in Rochester turned out to be justified in fact as two of the three restaurants opened there failed while the third is barely profitable.

We have examined the reasons offered by petitioners for the formation of the other four restaurant corporations and have found them to be either fantastic or merely unsupportable upon the record. We have set forth these reasons in detail in the Findings of Fact. Quite predictably petitioners have argued that the partners wished to limit their liability when opening up new locations even when there was no particular reason for believing that the new location would be unsuccessful. Petitioners have also claimed that several of the corporations were necessary to protect the various Host names from appropriation. Because the creation of any corporation will provide its shareholders with limited liability and prevent another corporation from getting a charter under the same name, we cannot take these arguments too seriously unless there is additional evidence showing the need for multiple corporations.

In light of the strong circumstantial evidence of intent to evade taxes provided by the existence of an integrated

business, the thin-capital structure and intercorporate borrowing, and the absence of believable business reasons for their formation, we find that the principal purpose for the formation of 309 Delaware, Royal, Main, and Telesnax was tax avoidance. Similarly, there is no reason evident upon the record other than tax avoidance that explains the formation of the real estate holding company, Alro, in 1951. Therefore, we find that the principal purpose for the partners' creation of Alro was tax avoidance.

Accordingly, we hold that respondent was correct in disallowing the surtax exemptions of 309 Delaware, Royal, Main, Telesnax, and Alro.

In the light of the foregoing,

Decisions will be entered for the respondent in docket Nos. 2675-69, 461-70, 1207-71, 2678-69, 450-70, 1199-71, 2681-69, 453-70, 1201-71, 2683-69, 455-70, 1203-71, 2684-69, 456-70, and 1206-71.

Decisions will be entered for the petitioners in docket Nos. 2676-69, 448-70, 1197-71, 2679-69, 451-70, 1200-71, 2680-69, 452-70, 2682-69, 454-70, 1202-71, 2685-69, 457-70, 1205-71, 2686-69, 458-70, and 1204-71.

Decisions will be entered under Rule 50 in docket Nos. 2673-69, 446-70, 1194-71, 2687-69, 459-70, 1195-71, 2677-69, 449-70, 1198-71, 2688-69, 460-70, and 1196-71.

APPENDIX B

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 242-268—September Term, 1973.
(Argued October 18, 1973 Decided December 11, 1973.)
Docket Nos. 73-1311-73-1337

YOUR HOST, INC., *et al.*,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

CHEF FOODS, INC., *et al.*,
Petitioners-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Before: KAUFMAN, *Chief Judge*, LUMBARD and TIMBERS, *Circuit Judges*.

Appeal from judgments of the United States Tax Court (Irwin, J.) in consolidated cases in which the Tax Court upheld determinations by the Commissioner, pursuant to 26 U.S.C. §§ 482 and 269, of income tax deficiencies for 1965 through 1968 regarding seven of petitioners-appellants' affiliated corporations.

Affirmed.

Appendix B

Ralph J. Gregg, Buffalo, New York (Albrecht, Maguire, Heffern & Gregg, and George M. Zimmermann, on the brief), Attorneys for Your Host, Inc., *et al.*, Petitioners-Appellants and Chef Foods, Inc., *et al.*, Petitioners-Appellees.

William A. Friedlander, Washington, D. C. (Scott P. Crampton, Assistant Attorney General, Ernest J. Brown and Richard S. Halberstein, Attorneys, Tax Division, Department of Justice, Washington, D. C., on the brief), Attorneys for Commissioner of Internal Revenue.

LUMBARD, *Circuit Judge*:

Petitioners-appellants, Your Host, Inc., and its affiliated companies, appeal from judgments of the United States Tax Court (Irwin, J.,) which upheld determinations by the Commissioner of income tax deficiencies assessed for the years 1965 through 1968. Your Host, Inc., *et al.*, 58 T.C. 10 (1972). The deficiencies were assessed pursuant to 26 U.S.C. § 482, which allows the Commissioner to allocate income among affiliated companies more properly to reflect the earning of income,[1] and pursuant to 26 U.S.C. § 269, which permits the Commissioner to deny tax exemptions

[1] 26 U.S.C. § 482 provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporatd, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

and deductions where an affiliated company was "acquired" for tax avoidance purposes.[2] We affirm.

Your Host, Inc., and its affiliates, operate a restaurant chain and food business in the Buffalo area. From modest beginnings in a one-restaurant partnership of A. J. Durrenberger and R. T. Wesson in 1944, the business grew so that by the mid 1960's it consisted of sixteen interrelated corporations which operated some forty "Your Host" restaurants, a food supply commissary, a bakery, a real estate holding company, and a vending machine and leasehold operations.[3] All of these enterprises remained

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[2] 26 U.S.C. § 269 provides in relevant part:

(a) In general.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance.

[3] The principal corporations among the group were Your Host, Inc., the original company begun as a partnership in 1944 and incorporated in 1947 and which now operates fifteen "Your Host" restaurants, and Sher-Del-Foods, Inc., also incorporated in 1947, which owns and runs the food processing part of the business. In addition to these two principal companies, there are ten subsidiaries and affiliates which run "Your Host" restaurants: 309 Delaware Ave., Inc., (four restaurants). Royal Host, Inc. (one), Boulevard Host, Inc. (two), Utica Host, Inc.

(Footnote continued on following page)

under the control of two original partners and later, after Wesson's death in 1956, under the control of Durrenberger alone.

Out of the sixteen companies the Commissioner, pursuant to 26 U.S.C. § 482, allocated the income of twelve of them to Your Host, Inc.[4] and the income of one of them (Your Host Bakery, Inc.) to Sher-Del Foods, Inc. He furthermore determined that, pursuant to 26 U.S.C. § 269, thirteen of the companies had been established for the principal purpose of tax avoidance and he accordingly denied them the corporate surtax exemptions.[5]

Upon review the Tax Court upheld the Commissioner's determinations under § 482 as to only two of the affiliated companies: the allocation of Chef Foods' income to Your Host, Inc., and the allocation of Your Host Bakery's income to Sher-Del Foods, Inc. The Tax Court held that the ten restaurant operating companies whose income had

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(Footnote continued from preceding page)
(four), Niagara Host, Inc. (four), Main Host, Inc. (three), Transit Host, Inc. (two), Sharlem Host, Inc. (three), Rochester Host, Inc. (originally three, now one), and Telesnax, Inc. (one). There is also Air Host, Inc., which runs the business's one "Royal Host" restaurant. The remaining three companies are Your Host Bakery, Inc. (supplier of bakery goods to the business), Chef Foods, Inc. (a subsidiary of Sher-Del which handles vending machine operations and which leases storage facilities to Sher-Del and Your Host Bakery), and Alro Realty, Inc. (another subsidiary of Sher-Del which owns the principal business property of Sher-Del and Your Host).

[4] These were the ten companies (aside from Your Host, Inc.) which operated "Your Host" restaurants (see fn. 3), plus Air Host, Inc., and Chef Foods, Inc.

[5] These were again the ten companies operating "Your Host" restaurants, plus Chef Foods, Inc., Your Host Bakery, Inc., and Alro Realty, Inc.

been allocated were "viable economic entities which earned their own income" and hence were not subject to income allocation.

The Tax Court also upheld the Commissioner's determinations under § 269 as to five of the affiliated companies: 309 Delaware Ave., Inc., Royal Host, Inc., Main Host, Inc., Telesnax, Inc., and Alro Realty, Inc. With respect to the other eight companies which had been denied surtax exemption, however, the court held as to six that the Commissioner had erred in finding that they had been established for the principal purpose of tax avoidance. The court did not assess the validity of the Commissioner's § 269 determinations as to Chef Foods and Your Host Bakery, having already sustained the Commissioner's 100% reallocation of the income of both companies under § 482.

Since the Commissioner has elected not appeal the Tax Court's finding adverse to the government,[6] we need concern ourselves here only with the Tax Court's findings[7] sustaining the Commissioner's determinations. As to these we note at the outset that the Commissioner's determinations are to be set aside only if "unreasonable, arbitrary, or capricious," in the case of § 482 allocations, *Wisconsin Big Boy Corp. v. C.I.R.*, 452 F.2d 137, 140 (7th Cir. 1971);

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[6] The Commissioner has filed a protective cross-appeal requesting that, in the event we reverse the Commissioner's § 482 determinations as to Chef Foods and Your Host Bakery, we remand to the Tax Court for consideration of the Commissioner's § 269 determinations with respect to both companies. Since we affirm the decision below, we need not consider this cross-appeal.

[7] We have not thought it necessary to recount all the findings of the Tax Court since they are set out in detail in its opinion, 58 T.C. 10 (1972).

Philipp Bros. Chemicals, Inc. v. C.I.R., 435 F.2d 53, 57 (2d Cir. 1970), and only if "clearly erroneous" in the case of denials of surtax exemptions under § 269, *Dorba Homes, Inc. v. C.I.R.*, 403 F.2d 502, 505 (2nd Cir. 1968); *J. T. Slocomb Co. v. C.I.R.*, 334 F.2d 269, 273-74 (2nd Cir. 1964).

Under these standards of review, we cannot say that the Commissioner's § 482 determinations were arbitrary or unreasonable. In the case of Chef Foods, Inc., whose income was allocated to Your Host, Inc., for the four years in question, it was found that Chef Foods was originally formed in 1958 to provide a vehicle for developing catering services in industrial plants. This line, however, was never developed. Instead Sher-Del Foods acquired all the stock of Chef Foods for $6,000. Chef Foods was then used to purchase cigarette vending machines which were placed only in "Your Hosts" restaurants. It purchased cigarettes wholesale and sold them through vending concessions at the restaurants, the profits being shared through concession commissions to each restaurant. Chef Foods also acquired refrigeration and storage facilities in Buffalo, almost all of which were leased to Sher-Del Foods and to Your Host Bakery. For these operations, Chef Foods utilized one employee, a vending machine repairman, whose salary and expenses constituted virtually all of the operating expenses of the company. Otherwise Chef Foods shared its aliquot portion of taxes, insurance, utility, and other costs along with the other corporations as summarily determined by the common executive management of the companies. The portion of Chef Foods' profit which Durrenberger, then the

surviving original partner, took as his salary was also similarly determined. Chef Foods' income from the vending machine sales and from rents averaged roughly $160,000 for each year between 1965 and 1968, with approximately 75% coming from the vending machines sales. Thus while it is true, as the dissent suggests, that Chef Foods conducted sizeable business operations in terms of cash flow, the very imbalance between the firm's posture on its balance sheets and the actual scope of its operations, in terms of its labor force, capitalization, work site, and so forth, suggests that the firm was kindred in nature to the kind of sham enterprise which this court held properly subject to income allocation in *Philipp Bros. Chemicals, Inc. v. C.I.R., supra.* At least, given Chef Foods' position within the "Your Host" group, it was not unreasonable for the Commissioner to have allocated the income of Chef Foods as he did. See also *Wisconsin Big Boy Corp. v. C.I.R., supra;* and *Hamburgers York Road, Inc.*, 41 T.C. 821 (1964).

For the same reasons we are constrained not to disturb the Commissioner's allocation of the income of Your Host Bakery, Inc., to Sher-Del Foods, Inc. The bakery sold its products only to Sher-Del. Sher-Del in turn sold these products to the various "Your Host" restaurants but at the same price at which it had bought them. The entire profit of the baking part of the enterprise thus went to the bakery even though Sher-Del Foods was the seller to the rest of the chain. In addition, although the bakery did employ a sizeable work force (unlike Chef Foods), it did share the same top-level management as Your Host, Inc., and Sher-Del Foods, Inc., with similar

apportionment of salaries and expenses. Furthermore, it shared the same premises with Sher-Del Foods.

Although not conceding the point, appellants contend that under these circumstances the Commissioner was at best entitled to allocate the bakery's income to Sher-Del only to the extent of determining a reasonable profit to Sher-Del for its services in distributing the bakery's products to the "Your Host" chain. The dissent endorses this position, and cites in support of it language in our decision in *W. Braun Co. v. C.I.R.*, 396 F.2d 264 (2d Cir. 1968). However, in view of the highly integrated nature of the business enterprise, we do not believe that it was unreasonable for the Commissioner to have concluded that all of the bakery's income should be attributable to Sher-Del. As we said in the later case of *Philipp Bros. Chemicals, Inc. v. C.I.R., supra*, at 59:

> [T]he taxpayer had the burden of showing that the 100% allocation of income to the [parent] corporation was unjustified. Taxpayers ask us to remand the case in order to allow them an opportunity to establish that the 100 per cent allocation was unreasonable and to show what a reasonable allocation would be. We see no reason for according them another chance. . . .

The petitioners here having similarly failed to demonstrate the reasonable allocation which they claim was their due, we believe our position as stated in the *Philipp* case is controlling. See also *Wisconsin Big Boy Corp v. C.I.R., supra*, at 140; *Ballentine Motor Co. v. C.I.R.*, 321 F.2d 796 (4th Cir. 1963); *Hall v. C.I.R.*, 294 F.2d 82 (5th Cir. 1961).

Appendix B

The Commissioner's determinations under 26 U.S.C. § 269, to disallow the surtax exemption for five of the appellants' corporations, were also within permissible limits.[8] We note that four of these five (Telesnax, Inc., Royal Host, Inc., Main Host, Inc., and 309 Delaware Ave., Inc.) were merely alternate vehicles for operating additional "Your Host" restaurants. They were all thinly capitalized. They were all financed by substantial loans from Your Host, Inc., and from Sher-Del Foods, Inc., loans either not evidenced by notes or established through a system of delayed billing. More importantly, in none of these four instances were the appellants able to proffer reasons for their separate incorporation other than a desire to limit liability for its own sake (which is in any event a necessary consequence of incorporation) and, in the case of Telesnax, the additional desire to give Wesson and Durrenberger's accountant a capital share in the business. Unlike the situation regarding the six "Your Host" companies where the Tax Court found the principal purpose of incorporation to have been other than tax avoidance, for these four restaurant operating corporations the appellants cited no unusual risks incumbent on the ventures, such as location in an untried shopping center development or in a community with strong pre-established competition, nor any other factors, such as the need to protect a corporate name not already protected or to protect the goodwill of a particular restaurant, which

[8] There is of course, no longer any question that the formation of a new corporation can be an acquisition for the purposes of § 269, *James Realty Co. v. United States*, 280 F.2d 394 (8th Cir. 1960), and also that § 269 applies to an acquired corporation as well as to an acquiring corporation, *Concord Supply Corp.*, 37 T.C. 919 (1962).

might have been persuasive of the necessity for separate incorporation.[9] Accordingly, the Commissioner's conclusion that tax avoidance was the principal purpose behind their separate incorporation was not "clearly erroneous." See *Scroll, Inc. v. C.I.R.*, 447 F.2d 612 (5th Cir. 1971); *Bobsee Corp. v. United States*, 411 F.2d 231 (5th Cir. 1969); *Borge v. C.I.R.*, 405 F.2d 673 (2d Cir 1968).

Although incorporated for reasons other than operating a "Your Host" restaurant, Alro Realty, Inc., presents no different considerations in regard to the Commissioner's disallowance of its surtax exemption. Appellants argued before the Tax Court that the principal purpose for establishing Alro was to facilitate real estate mortgage financing for the overall enterprise. Yet, the operation of Alro subsequent to its formation undercuts that contention.

Alro was created by Wesson and Durrenberger in 1951 with a capitalization of $2,000. It then purchased all of Sher-Del Foods' business real estate, including the commissary building, by delivering promissory notes totalling $112,822.93, but failed to assume Sher-Del's prior mortgage obligation. Moreover, although Alro has repaid a mere $3,000 on these notes, Sher-Del has continued making capital advances to Alro. In sum, Alro has never been utilized as a financing vehicle or in any other manner to improve the working capital position of its parent, Sher-Del, or its affiliate, Your Host, Inc. On these facts the

[9] The circumstances which the dissent urges as justifying the separate incorporation of 309 Delaware Ave., Inc., for example the slightly higher rent, the smaller number of pedestrians, and so forth, are marginal at best. These factors are not equivalent to such substantial risks as taking on established competition or beginning business operations in a city where the "Your Host" name was generally unknown.

Commissioner was not clearly erroneous in determining that Alro was established for the principal purpose of tax avoidance. See *Bobsee Corp. v. United States, supra*, at 238; *Dorba Homes v. C.I.R., supra*, at 505-506.

The only troublesome point which remains concerns the apparent inconsistency of the Tax Court's conclusions under §§ 482 and 269. The four restaurant operating corporations of the "Host" group which have been denied the surtax exemption because of their "acquisition" for the principal purpose of tax avoidance were also found, however, to have "sound business reasons" for the separate corporate existence, so that as to them the Tax Court reversed the Commissioner's income allocations under § 482. This apparent inconsistency is resolved by the fact that a company may operate from day to day as a valid economic entity although it may have originated as a tax avoidance device. Sections 482 and 269 of the Code look to different periods in a corporation's existence, as they also look to different elements of proof; economic reality in reference to income versus inference of intent in reference to tax savings. Thus even though the establishment of these elements requires in part the assessment of common facts in the conduct of a company after its "acquisition," the purposes relevant to such assessment may be quite distinct. In a case very similar to the present one, this court cautioned against

> confus[ing] "a purpose," the continued existence of which may be enough to eliminate [an adverse determination under § 482], with "the principal purpose" to evade or avoid the Federal income tax, the initial presence of which governs § 269 and which may exist alongside other secondary reasons for the formation of the corporation.

Dorba Homes, Inc. v. C.I.R., supra, at 506. That caution is no less applicable to the facts of the instant case.

We find no merit in the appellants' final contention that the application by the Commissioner of the sanctions of § 269 "so many years after the fact" is a violation of the due process clause.

The judgments of the Tax Court are accordingly affirmed.

TIMBERS, *Circuit Judge* (dissenting in part):

Since I am disturbed by certain inconsistencies in the Tax Court decision and by the majority's placing the imprimatur of our Court on those inconsistencies, I respectfully dissent in part.

With respect to the Section 482 allocations, I dissent from the majority opinion to the extent that it affirms the Tax Court in upholding the Commissioner's allocation of Chef Foods' income to Your Host and his allocation of the entire income of Your Host Bakery to Sher-Del Foods. As to the Chef allocation, I would reverse. As to the Bakery allocation, I would reverse, and remand for determination of a proper adjustment and a reallocation of income.

With respect to the Section 269 surtax exemptions, I agree with the majority's affirmance of the Tax Court in upholding the Commissioner's disallowance of surtax exemptions for four of appellant's five affiliated companies. As to the 309 Delaware restaurant, however, I would reverse and hold that the Commissioner's disallowance of its surtax exemption was clearly erroneous.

Appendix B

I.

Section 482 of the Internal Revenue Code of 1954, 26 U.S.C. § 482 (1970), authorizes the Commissioner to "allocate gross income" among the units of commonly controlled business organizations. Its purpose is to prevent tax evasion or clearly to reflect the income of the various parts of an integrated corporate group. While this statute gives the Commissioner broad discretion to allocate income, it does not permit him to disregard a separate corporate entity if it exists for "a bona fide business purpose", *W. Braun Co. v. C.I.R.*, 396 F.2d 264, 268 (2 Cir. 1968), and if it conducts substantial business activities and earns its own income. *Philipp Brothers Chemicals, Inc. v. C.I.R.*, 435 F.2d 53 (2 Cir. 1970). Nor does this statute permit the Commissioner to substitute his business judgment for that of management. The fact that a parent corporation might have performed services for itself rather than establishing a subsidiary for that purpose is irrelevant so long as the latter is a viable, going concern. *Philipp Brothers Chemicals, Inc. v. C.I.R., supra*, 435 F.2d at 58. Income allocation is proper only when the income earned by one corporation is artifically deflected to another.[1]

Applying these criteria to the instant case, the Tax Court held that the ten restaurant corporations were "economically viable business entities". 58 T.C. at 27. It refused to uphold the Commissioner's allocation of their income to Your Host. The Tax Court based its conclusion on the

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[1] See 7 Mertens, Law of Federal Income Taxation § 38.63 (Zimet & Barton rev., 1967):

> "The identity of business is to be preserved and the Secretary or his delegate has no authority under [§ 482] to merge them into one single business unless the businesses are carried on and manipulated in such a way as to constitute one single business, or unless the 'controlled enterprise' is a sham" (citations omitted).

fact that these corporations earned their own income and paid their own costs of doing business.[2]

If the Tax Court was correct in holding such operational autonomy to be a bar to income allocation with respect to the ten restaurant corporations, I fail to understand the majority's conclusion with respect to Chef Foods. Chef was a viable, independently functioning business enterprise. It had cigarette vending machine sales averaging $130,000 per year; it had a salaried employee for whom it paid workmen's compensation and social security contributions; it owned its own vending machines and maintained a substantial inventory; it paid its own utilities, taxes, automobile expenses and, as did the ten restaurant corporations, a proportionate share of group insurance and general administrative costs.[3] Chef conducted its business no differently than did its competitors. It serviced its own machines, collected receipts and paid commissions based upon the amount of merchandise sold.

These factors clearly distinguish the instant case from *Philipp Brothers Chemicals, Inc. v. C.I.R., supra.* There we affirmed the Tax Court in sustaining the Commissioner's allocation of the entire income of foreign sales subsidiaries to their parent upon a finding that they had no employees, no inventory and did nothing whatever to earn

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[2] Each of the ten restaurant corporations paid for its own non-administrative help, supplies, utilities, state and federal taxes, social security contributions, fire insurance premiums and license fees. Each was solely responsible for payment of its own rent. Each paid a proportionate share of the common administrative and group insurance costs.

[3] The majority notes that Chef had insubstantial business expenses. As long as Chef was a viable enterprise and received no services from Your Host for which the latter was not adequately compensated—*i.e.* no income distortion—that fact would appear irrelevant.

the income they reported. That is a far cry from the situation here.

The case against allocating all of Your Host Bakery's income to Sher-Del Foods is even more compelling. Bakery had sales in excess of $175,000; it had a payroll of approximately $50,000; it purchased more than $80,000 worth of raw materials; and it paid for its own insurance, linen, laundry and operating supplies. These are clear indices of operational autonomy. They demonstrate that Bakery was a viable, income earning enterprise. I see no basis for the Tax Court's conclusion that Bakery "could hardly be considered to have conducted any business." 58 T.C. at 28-29.

True, Bakery sold its entire output through Sher-Del which acted without charge as Bakery's middleman, delivery and billing agent. There was some income distortion. This does not mean, however, that a Section 482 allocation of 100% of the subsidiary's income is appropriate. While Sher-Del has not established the adjustment necessary to reflect the cost to it of these services, it has demonstrated that Bakery earned a substantial portion of its reported income. In an analogous situation, we held that

> "[t]he Commissioner was . . . not justified in arbitrarily allocating *all* of [the subsidiary's] taxable income to petitioner." *W. Braun Co. v. C.I.R. supra*, 396 F.2d at 268. (emphasis added).

I would remand for a determination of the proper adjustment of Sher-Del's costs as a basis for reallocating Bakery's income to Sher-Del according to law.[4]

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[4] A proper adjustment would involve an increase in Sher-Del's income sufficient to reflect the cost to it of the billing and delivery services provided for Bakery and a corresponding decrease in Bakery's income.

Appendix B

II.

Since Your Host did not demonstrate non-tax avoidance reasons for the separate incorporation of Telesnax, Inc., Royal Host, Inc., Main Host, Inc. and Arlo Realty, Inc., the Tax Court correctly upheld the Commissioner's disallowance of their surtax exemptions pursuant to Section 269 of the Internal Revenue Code of 1954, 26 U.S.C. § 269 (1970).

The specific findings of the Tax Court with respect to 309 Delaware Ave, Inc.,[5] however, establish that it was formed for the very reasons said to have justified the formation of the eight other "Host" companies as to which the Tax Court found the principal purpose of incorporation to have been other than tax avoidance. These findings by the Tax Court strike me as undermining the majority's assumption that there were "no unusual risks . . . which might have been persuasive of the necessity for separate incorporation" of 309 Delaware. I would hold that the Commissioner's disallowance of its surtax exemption was clearly erroneous. See *Borge v. C.I.R.*, 405 F.2d 673 (2d Cir. 1968).

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[5] The Tax Court found with respect to the 309 Delaware restaurant:

"The prospects for a restaurant at 309 Delaware Avenue were not as favorable as those enjoyed at the other Your Host locations. The rent was higher there than for other locations ($250 to $300 per month over a seven-year period compared to a $200 maximum per month on a ten-year lease at 3232 Bailey Avenue). There were no adjacent parking facilities and pedestrian traffic was not as heavy as at other locations." 58 T.C. at 14.

APPENDIX C

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the eleventh day of December one thousand nine hundred and seventy-three.

Present: HON. IRVING R. KAUFMAN, *Chief Judge*.
HON. J. EDWARD LUMBARD,
HON. WILLIAM H. TIMBERS, *Circuit Judges*.

YOUR HOST, INC., ALRO REALTY, INC., MAIN HOST, INC., ROYAL HOST, INC., TELESNAX, INCORPORATED, 309 Delaware Ave., Inc, SHER-DEL FOODS, INC.,

Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee-Appellant.

Tax Court Docket Nos. 2673-69, 2675-69, 2678-69, 2681-69, 2683-69, 2684-69, 2687-69, 446-70, 450-70, 453-70, 455-70, 456-70, 459-70, 461-70, 1194-71, 1195-71, 1199-71, 1201-71, 1203-71, 1206-71, 1207-71.

73-1311 thru 73-1337.

Appendix C

Appeal from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States , and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the orders of said The Tax Court of the United States be and they hereby are affirmed with costs to be taxed against the petitioners-appellants.

A. DANIEL FUSARO,
Clerk.

BY: VINCENT A. CARLIN,
Chief Deputy Clerk.

APPENDIX D

Sec. 482. Allocation of Income and Deductions Among Taxpayers.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Sec. 269. Acquisitions Made to Evade or Avoid Income Tax.

[Sec. 269(a)]

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation.

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For the purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

REGULATIONS

§ 1.482-1 Allocation of income and deductions among taxpayers.—

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or

of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

* * *

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions credits, and allowances to be used by the district director in any case, including the form of the adjustments and the

character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory) or any other adjustment which may be appropriate under the circumstances. See § 1.482-2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U. S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U. S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the U. S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no affect on the U. S. income tax

liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U. S. income tax liability of such member for a later taxable year, or for the purposes of determining the U. S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

* * *

§ 1.482-2. Determination of taxable income in specific situations.—

(b) *Performance of services for another*—(1) *General rule.* Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in subparagraph (3) of this paragraph, the district director may make appropriate allocations to reflect an arm's length charge for such services.

(2) *Benefit test.* (i) Allocations may be made to reflect arm's length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities, as well as with respect to services

performed by one member of the group exclusively for the benefit of another member of the group. Any allocations made shall be consistent with the relative benefits intended from the services, based upon the facts known at the time the services were rendered, and shall be made even if the potential benefits anticipated are not realized. No allocations shall be made if the probable benefits to the other members were so indirect or remote that unrelated parties would not have charged for such services. In general, allocations may be made if the service, at the time it was performed, related to the carrying on of an activity by another member or was intended to benefit another member, either in the member's overall operations or in its day-to-day activities. The principles of this subdivision may be illustrated by the following examples in each of which it is assumed that X and Y are corporate members of the same group of controlled entities:

* * *

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In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 73-1652

YOUR HOST, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A 16-51) are reported at 58 T.C. 10. The opinion of the court of appeals (Pet. App. B 52-67) is reported at 489 F. 2d 957.

JURISDICTION

The judgment of the court of appeals was entered on December 11, 1973 (Pet. App. C 68-69). A petition for rehearing was denied on February 6, 1974 (Pet. App. C 69). The petition for a writ of certiorari was filed on May 7, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether Section 482 of the Internal Revenue Code of 1954 empowers the Commissioner to reallocate all of

the income reported by one commonly controlled corporation to another such corporation.

2. Whether Section 482 empowers the Commissioner to reallocate income from one commonly controlled corporation to another, even though the tax result achieved is the same as a disallowance of the Section 11(d) $25,000 corporate surtax exemption of the corporation from which the income is reallocated.

3. Whether the Commissioner's determination, that the acquisition of a corporation was for the principal purpose of tax evasion or avoidance within the meaning of Section 269 of the Code and that the acquired corporation therefore was not entitled to the corporate surtax exemption, constitutes a denial of due process because previous audits had not resulted in such a determination.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INDOME TAX.

(a) *In General.* If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between, or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

STATEMENT

Petitioner and its affiliates operate a restaurant chain and food business in the Buffalo, New York, area. The business began in 1944 as a single-restaurant partnership between A. J. Durrenberger and R. T. Wesson. During the

period 1947 through 1958, the business expanded and a group of corporations under common control was organized to engage in the operation of restaurants, a food supply commissary (Sher-Del-Foods, Inc.), a bakery (Your Host Bakery, Inc.), a real estate holding company (Alro, Inc.), and vending machine and leasehold operations. Petitioner Your Host, Inc., the first and principal corporation of the group, owns and operates fifteen "Your Host" restaurants. The other restaurants are owned by ten different corporations, none of which have more than four restaurants. All of these enterprises remained under the control of the two original partners and later, after Wesson's death in 1956, under the control of Durrenberger alone (Pet. App. B 54-55 and n. 3).

Pursuant to the Commissioner's authority under Section 482 of the Code to allocate income between commonly controlled corporations, if he determines that such allocation is necessary in order to prevent evasion of taxes or clearly to reflect their income, all of the income reported by the ten restaurant corporations and by Chef Foods, Inc., for their taxable years ending in 1965 through 1968, was allocated to petitioner Your Host, Inc. The Commissioner further allocated for these years all of the income reported by Your Host Bakery, Inc., to Sher-Del-Foods, Inc. The Tax Court sustained the allocations of the income of Chef Foods and Your Host Bakery but not of the ten restaurant corporations (Pet. App. A 45-46). However, the Tax Court sustained the Commissioner's alternative position under Section 269 of the Code disallowing the $25,000 corporate surtax exemptions of four of the restaurant corporations and of Alro, the real estate corporation, on the ground that the principal purpose for the formation of these corporations was the

avoidance of taxes (Pet. App. A 46).[1] The court of appeals affirmed, with one judge dissenting in part.

ARGUMENT

1. Section 482 of the Internal Revenue Code of 1954 empowers the Commissioner to "allocate gross income" among commonly controlled business entities, if he determines that such allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such business entities. The statute is based upon the "well-settled policy that income is taxable under Section 61 of the 1954 Code to the party who earns it and that it is economic reality rather than legal formality which determines who earns income." *Philipp Brothers Chenicals, Inc. (N.Y.)* v. *Commissioner*, 435 F. 2d 53, 57 (C.A. 2). At the time of its original enactment as Section 45 of the Revenue Act of 1928 the scope of the provision was explained in H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17, as follows:

> The section of the new bill provides that the Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods

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[1] Because the Tax Court sustained the Commissioner's primary Section 482 allocation of the income of Chef Foods and Your Host Bakery to Your Host and Sher-Del-Foods, it did not have to reach the alternative Section 269 issue concerning disallowance of the corporate surtax exemptions of Chef Foods and Your Host Bakery. We have accordingly filed a petition for a writ of certiorari (No. 73-1687) in order to protect the revenue by preserving this alternative position. The petition in No. 73-1687 should be granted only if the Court grants this petition.

frequently adopted for the purpose of "milking"), and in order clearly to reflect their true tax liability.

As this Court recognized in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, 400, the relevant Treasury Regulation (Section 1.482-1(b)(1)), provides that the standard to be applied under Section 482 is "'that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.'" Thus, Section 482 empowers the Commissioner to examine transactions between controlled taxable entities in order to determine whether they would have been concluded in an arm's-lenth negotiation between strangers, and to make a reallocation when they fail to meet that standard. It is firmly established that such determinations can be set aside only if unreasonable, arbitrary, or capricious. See, *e.g.*, *Wisconsin Big Boy Corp.* v. *Commissioner*, 452 F. 2d 137, 140 (C.A. 7), and cases cited therein.

Petitioners principally argue (Pet. 10-12) that there is a fundamental conflict among the circuits as to the scope of the Commissioner's authority under Section 482. They urge that the Commissioner is never authorized to allocate all of the income of one corporation to another because the result would be equivalent to the result achieved by the filing of a consolidated return. In support of their position, petitioners cite *Commissioner* v. *Chelsea Products, Inc.*, 197 F. 2d 620 (C.A. 3), and assert a conflict between that case and the decision below and *Wisconsin Big Boy Corp.* v. *Commissioner, supra.*

This position, however, was rejected long ago by the Second Circuit in *Advance Machinery Exch.* v. *Commissioner*, 196 F. 2d 1006, certiorari denied, 344 U.S. 835, which upheld an allocation of all of the income of several

controlled entities to another.[2] In rejecting the contention that the statute did not authorize a total allocation, the court noted that such a rule "would exclude from the 'policing' provisions of § [482] the most flagrant evasion by arbitrary shifting of income." The court further observed that if such a limitation were imposed upon the Commissioner's authority, "tax evasion could be so complete as to make itself invulnerable, a proposition whose statement discloses its fallacy" (196 F. 2d at 1009). And, contrary to petitioner's argument, *Chelsea Products* did not hold that the Commissioner cannot as a matter of law allocate all of a corporation's income under Section 482. While there is dictum in *Chelsea Products* suggesting that the Commissioner's allocation "proceeded beyond his statutory bounds" (197 F. 2d at 623), the Third Circuit emphasized that the basis of its decision was the Tax Court's finding that the corporations involved each conducted a business enterprise separate from the taxpayer and that their income was not earned by the taxpayer. The court distinguished the Second Circuit's *Advance Machinery* decision (rendered one month before) on this ground (197 F. 2d at 623-624, n. 6), and this Court denied a petition for a writ of certiorari in *Advance Machinery* which had urged the same alleged conflict with *Chelsea Products* urged by petitioners here. Significantly, no case since *Chelsea Products* has even suggested that the Commissioner cannot allocate all of a corporation's income merely because

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[2]Thus, petitioners' contention (Pet. 10-11) that the courts did not permit total allocations until the 1964 decision of the Tax Court in *Hamburger's York Road, Inc.* v. *Commissioner*, 41 T.C. 821, is refuted by the *Advance Machinery Exchange* decision which was rendered in 1952.

the result achieved is similar to that under a consolidated return.[3]

3. Petitioners further contend (Pet. 9) that the total allocation of the income of Chef Foods and Your Host Bakery cannot stand because a lesser allocation was more appropriate. But as the court of appeals observed with respect to Chef Foods, "the actual scope of its operations, in terms of its labor force, capitalization, work site, and so forth, suggests that the firm was kindred in nature to the kind of sham enterprise which [that] court held properly subject to income allocation in *Philipp Bros. Chemicals, Inc.* v. *C.I.R.* [435 F. 2d 53]" (Pet. App. B 58). Indeed, petitioners have pointed to nothing in the record which suggests that Chef Foods earned any of the income it reported. Thus, while purchases and sales of cigarettes in vending machines located in "Your Host" restaurants and rental of refrigeration and storage facilities were conducted in the name of Chef Foods, the record indicates that it incurred no office, telephone, or automobile expenses, sustained $179 of repair expenses, and purchased $160 of operating supplies during the four years at issue (Pet. App. B 57; R. 277-282, Exs. 79-CA through 82-CD).[4] In light

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[3] *W. Braun Co., Inc.* v. *Commissioner*, 396 F. 2d 264 (C.A. 2), cited by petitioners (Pet. 7-10), is not to the contrary. Apart from the fact that it does not establish an inter-circuit conflict, the court there rejected a Section 482 allocation of all of a corporation's income because it conducted substantial business activities and earned its own income.

Nor does Section 1.482-1(b)(3) of the Treasury Regulations (Pet. 7) prevent the Commissioner from making a total allocation under Section 482. As the Second Circuit explained in *Advance Machinery*, that provision simpy means that the Commissioner is not free to compel affiliated corporations to file a consolidated return (196 F. 2d at 1009).

[4] "R." and "Ex." references are respectively to the joint appendix filed in the court of appeals and the trial exhibits.

of this gross imbalance between Chef Foods' annual receipts ($160,000) and its virtually non-existent expenses, both courts below were amply justified in concluding that the Commissioner's allocation of all of its income was neither arbitrary nor unreasonable.

Petitioners have likewise failed to show that the Commissioner's allocation of all of Your Host Bakery's income to Sher-Del-Foods was arbitrary or unreasonable. It is undisputed that the bakery sold virtually all of its products to Sher-Del-Foods, which in turn sold them at its cost to the various "Your Host" restaurants. Thus, the entire profit of the baking part of the enterprise was shifted to Your Host Bakery despite the fact that Sher-Del-Foods would have received part of the profit if sales of the baked goods had been made to an unrelated third party. It is therefore beyond doubt that these sales did not meet the standard prescribed by Treasury Regulations, Section 1.482-1(b) (1) of "an uncontrolled taxpayer dealing at arms's length with another uncontrolled taxpayer."

Although petitioners appear to acknowledge (Pet. 9) that some allocation of income from Your Host Bakery to Sher-Del-Foods would be proper, they claim to have proved that an allocation of less than 100 percent is required. They urge that they are entitled to a remand to the Tax Court in order to prove the exact amount of the correct allocation. But it is well settled that a taxpayer seeking to overcome a Section 482 allocation has the burden of proving more than simply that the allocation may be erroneous. The burden of proving that a Section 482 determination by the Commissioner is arbitrary requires a showing as to what other allocation would have been more appropriate under the "arm's length" standard of the statute. See *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, 258-259, affirmed, 202 F. 2d 873 (C.A. 5); *Wisconsin Big Boy Corp.* v. *Commissioner, supra*, 452 F. 2d at 140.

Thus, a generalized claim that a total allocation is inappropriate, without more, is insufficient to overturn a Section 482 allocation. In order to demonstrate that such an allocation is arbitrary or unreasonable, the taxpayer must come forward with proof of what allocation, if any, would be proper. Here, the only evidence petitioners submitted was the gross income and expenses as reported by Your Host Bakery and the number of its employees. Petitioners claim that a total allocation cannot be sustained in light of those facts. But petitioners introduced no evidence to show what profits a bakery enterprise comparable to Your Host Bakery should have earned or what profits Sher-Del-Foods earned prior to the formation of Your Host Bakery when it dealt with an uncontrolled bakery. Thus, on this record, the Tax Court had no basis upon which to approve a lesser allocation of income from Your Host Bakery to Sher-Del-Foods. In these circumstances, the courts below had little alternative other than to sustain the Commissioner's allocation as neither arbitrary nor unreasonable. As the Second Circuit stated in *Philipp Brothers Chemicals, Inc. (N.Y.)* v. *Commissioner, supra,* 435 F. 2d at 59, in a passage the court of appeals found equally appropriate here (Pet. App. B 59):

> [T]he taxpayer had the burden of showing that the 100% allocation of income to the [parent] corporation was unjustified. Taxpayers ask us to remand the case in order to allow them an opportunity to establish that the 100 percent allocation was unreasonable and to show what a reasonable allocation would be. We see no reason for according them another chance. * * *

Contrary to petitioner's assertion (Pet. 9), the decision below does not conflict with *Helvering* v. *Taylor*, 293 U.S. 507. In that case, which did not involve Section 482, this Court held that where specific valuation evidence sub-

mitted by the taxpayer to the Board of Tax Appeals demonstrated that the Commissioner's apportionment of cost between two kinds of stock was arbitrary and excessive, it could not sustain the Commissioner's determination on the ground that the taxpayer did not introduce any evidence showing the correct amount of the tax. Under those circumstances, the Court declared that the Board should have held a further hearing to receive additional evidence in accordance with its statutory obligation under the predecessor of Section 6213(a) to conduct "a redetermination of the deficiency." See also Section 7459. Here, however, the Tax Court did not sustain the Commissioner's Section 482 determination in the face of any cogent evidence that it was either arbitary or unreasonable. Indeed, no such finding could have been made in light of petitioner's utter failure to meet its special burden of proving the allocation arbitrary or unreasonable by showing what the correct allocation would be under the "arm's length" standard of Section 482.[5]

---

[5]Nor do *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F. 2d 182 (C.A. 7) or *Lufkin Foundry & Machine Co.* v. *Commissioner*, 468 F. 2d 805 (C.A. 5)(Pet. 9), conflict with the decision below. In the former case, the district court concluded that the Commissioner's allocation of total income was arbitrary and unreasonable. The court of appeals found that certain evidence submitted by the taxpayer contained erroneous assumptions which would unquestionably require a modification of the district court's decision. Accordingly, it remanded the case for recomputation of the allocation in light of its opinion.

Lufkin does not involve a total allocation. There the Tax Court held that the evidence submitted by the taxpayer was sufficient to set aside the Commissioner's Section 482 allocation of 50 percent of two corporations' income. The court of appeals held, however, that the Tax Court erred in reaching this conclusion on the basis of analyses of the taxpayer's marketing arrangements rather than on proof of prices charged between similar uncontrolled taxpayers. Under these circumstances, where the Tax Court employed an erroneous standard of the taxpayer's burden of proof, the government conceded that it was appropriate to permit the taxpayer an opportunity to adduce additional evidence on a remand where the correct standard would be employed. Here, however, the Tax Court applied the correct burden of proof standard and petitioners failed to meet that burden.

4. Petitioners renew their suggestion (Pet. 11-12), advanced in the courts below, that the Commissioner's allocations were inproper because the result achieved is the same as would have followed from disallowance under Section 269 of the surtax exemptions of the corporations from which the income was reallocated to petitioners. But Congress specifically contemplated the possibility that Sections 269 and 482 would be alternative means for combatting the use of multiple corporations for the purpose of gaining additional surtax exemptions. Thus, S. Rep. No. 2375, 81st Cong., 2d Sess., p. 70, states:

> It is not intended, however, that the exemption of the first $25,000 of a corporation's surtax net income from the surtax shall be abused by the splitting up, directly or indirectly, of a business enterprise into two or more corporations or the forming of two or more corporations to carry on an integrated business enterprise. It is believed that sections 45 [now Section 482] *and* 129 [now Section 269] will prevent this form of tax avoidance. [Emphasis supplied.]

5. Finally, petitioners urge (Pet. 12-13) that the disallowance by the Commissioner of the surtax exemptions under Section 269 after taking no such action in prior audits is a violation of their rights to due process. The Commissioner, however, is not estopped from correcting past errors of his agents in auditing returns for earlier years. *Automobile Club* v. *Commissioner*, 353 U.S. 180. The only proper question is whether the action taken for the year in issue is correct. The courts below correctly held that it was, and there is no reason for further review by this Court.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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No. 73-1652

IN THE

Supreme Court of the United States

October Term, 1974

YOUR HOST, INC., *et al.*,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

Purpose for use of § 482 tacitly admitted

The real significance of the Response filed by the Solicitor General is his tacit admission that the only reason the Commissioner consolidated the income of these corporations under § 482 was to disallow surtax exemptions by the adroit trick of putting all of the income of fourteen of them on the tax returns of the first two corporations formed by Wesson and Durrenberger.

The Solicitor General requested an extension of time to confer with the Internal Revenue Service about certain of the contentions in the Petition. If he conferred about this, he found that the revenue agents had candidly explained to the petitioners that this was exactly what they were doing.

In defense of this action, he argues that "Congress specifically contemplated the possibility" that revenue agents would use §§ 482 and 269 interchangeably, quoting two sentences from a Senate Committee Report which were never intended to be interpreted in this cavalier fashion (Response, p. 12).

Response attempts to confuse the facts and issues

Otherwise, in what purports to be a Response to the Petition, the Solicitor General has misconstrued, misstated, twisted, distorted, and even tortured the issues, the petitioners' contentions, the facts and the decisions of the Circuit Courts for no apparent reason other than to confuse and mislead this Court.

As to the Section 482 Issue

1. This is immediately apparent from the Solicitor General's version of the issue. The way he would have it is whether the Commissioner may use § 482 "to reallocate all of the net income of one commonly controlled corporation to another such corporation". (Response, pp. 1-2).

This is a simplistic straw man. Surely he can if the owner arbitrarily shifts income from a genuine corporation that earns it to a phony or sham corporation that doesn't.

But that is neither the issue nor the facts of this case. Here, there was no shifting or distortion of income of any description by the owners to be reallocated under any Section of the Code. It was the Commissioner who arbitrarily shifted the income of thirteen healthy and viable, taxable entities to a fourteenth (and of the fifteenth to a sixteenth) so that he could tax all but the first $25,000.00 of the total at 48% and thereby deprive fourteen corporations of their right to have up to $25,000.00 apiece taxed to 22%.

2. The Solicitor General repeated this ploy by rephrasing the second question as though it were a mere coincidence that the Commissioner's 100% allocation deprived fourteen of sixteen corporations of their surtax exemptions (Response, p. 2).

It was not a mere coincidence. The revenue agents candidly explained that this was their reason for using § 482—not to reallocate income shifted by the owner—but to *indirectly* disallow surtax exemptions and, if that strategy did not succeed, to disallow their surtax exemptions *directly* under § 269.

As to the Petitioners Contentions and the facts

The Solicitor General adheres to the same pattern throughout his Brief—subtly misstating the petitioners' contentions to provide himself with easy answers and to mislead and confuse the Court. The major misstatements are discussed below:

1. Petitioners *did not* "urge that the Commissioner is never authorized to allocate all of the net income of one corporation to another because the result would be equivalent to the result achieved by the filing of a consolidated return" (Response, p. 6).

The Solicitor General said this so that he could cite *Advance Machinery Exch. v. Commissioner*, 196 F. 2d 1006, cert. den., 344 U.S. 835, for the proposition that this interpretation would permit "the most flagrant evasion by the arbitrary shifting of income" (Response, p. 7); thereby creating the false impression that there was some evidence of evasion here.

Advance Machinery was a case in which:

> "There was evidence that large numbers of purchase invoices had been altered to attribute them to one or another of these taxpayers and that these changes were made without any set policy to indicate that there was any motive in doing so other than to divert income from the petitioner."
>
> "The two (father and son) operated the business . . . in such a way that the net profit of each (of the four businesses) could be manipulated as they saw fit". 196 F. 2d 1006, at 1008.

The Second Circuit in *Advance Machinery* did not, as the Solicitor General claims (Response, p. 6) reject the decision of the Third Circuit in *Commissioner v. Chelsea Products, Inc.*, 197 F. 2d 620. On the contrary, it said:

> "This is consistent with the manner in which § 45 is applicable; the reallocation of income thereunder being based not on a disregard of taxable entities but on the *correction of business entries*". 196 F. 2d 1006, 1010.

Chelsea Products stands solidly for the proposition for which the petitioners actually contend—that the Commissioner may not disregard corporate entities and use § 482 to consolidate the net income of corporations which were formed for sound business reasons, conducted their own businesses and earned their own income.

2. The Solicitor General creates the inference that the Commissioner "examined transactions between (these) controlled taxable entities in order to determine whether they would have been concluded in an arms-length negotiation between strangers and made a reallocation where they failed to meet that standard". (Response, p. 6). This is false.

The revenue agents didn't even inquire into intercorporate transactions. They said that Durrenberger had the benefit of too many surtax exemptions; that *Hamburger's York Road* had shown them the way to nullify surtax exemptions by using § 482 instead of § 269; but that they would also set up deficiencies under § 269 anyway to protect the revenues.

3. The petitioners *did not,* as the Solicitor General claims (Response, p. 7), cite *Commissioner v. Chelsea Products, Inc., supra,* for the proposition that "the Commissioner cannot as a matter of law allocate all of a corporation s income under § 482". Of course he can if a common owner, as in *Advance Machinery,* arbitrarily diverts income from a corporation that earns it to dummy or sham corporations to evade taxes.

There is no conflict among the Circuits as to this question. But a very serious conflict has arisen among the Circuits, as explained in the petition, where the separate corporations actually earn and report their own income.

4. The Solicitor General's version of the income and expense of Chef Foods, Inc. appearing on Pages 8 and 9 of his Response is absolutely untrue. The Solicitor General would have the Court believe that Chef Foods, Inc. had annual receipts averaging $160,000.00 for the four years of issue but that it spent only $179.00 for repairs and $160.00

for supplies during that period, leaving it with a net profit in the excess of $159,900.00 annually. This is not only absurd but grossly false and deceptive.

The exhibits from which the Solicitor General purports to extract this information show that Chef Foods paid out an average of $100,105.00 a year for inventories and an average of $25,829.75 a year for salaries and wages, office and administration and car expense, rent, real estate taxes, sales taxes, utilities, insurance, licenses and for depreciation on buildings and equipment, leaving an average net profit of only $37,866.75 per annum.

It is also undisputed in the record that Chef Foods, Inc. paid its own bills and earned its own income; that Your Host, Inc. operated retail restaurants and nothing more, did not engage in the cigarette vending machine business, had no interest in the real estate from which Chef Foods derived over $30,000.00 of its gross income and did absolutely nothing to earn the income of Chef Foods, Inc.; that there was no basis for allocating the income of Chef Foods, Inc. to Your Host, Inc. and that Your Host, Inc. was chosen only because it was Durrenberger's first corporation.

5. The Solicitor General's defense of the 100% allocation of the income of Your Host Bakery, Inc. to Sher-Del Foods, Inc. demonstrates the validity of the petitioners contentions—that the Circuit Courts are confused as to the rule to be applied where a 100% allocation is obviously arbitrary and inappropriate and a remand would afford the taxpayer an opportunity to prove the exact dollar amount of the allocation the Court defined as being the proper one.

Here the finding was that Sher-Del Foods, Inc. had not charged Your Host Bakery, Inc. for billing and delivery

expense. The Solicitor General defends the Second Circuit in denying the petitioner the opportunity, on remand, to prove the exact dollar amount. Both are in disagreement with the Supreme Court and the Fifth and Seventh Circuits, the Solicitor General's wordy protestations (Response, pp. 10-11) to the contrary notwithstanding.

6. The petitioners *did not* claim that it is a violation of due process if the Commissioner reverses determinations made by his agents in prior audits (Response, p. 12).

The violation of due process described on Pages 12-14 of the petition was not considered in Automobile Club v. Commissioner, 355 U.S. 180, which involved the correction by the Commissioner of "a mistake of law" by a retroactive ruling.

Here the Commissioner and the Trial Court deprived the taxpayers of a fair trial of the issues, the Commissioner by raising the issue for the first time after everybody was dead and the facts were buried in history and the Trial Court by refusing to hear any evidence that might show that the Commissioner and his agents were being unreasonable, arbitrary and unfair.

Conclusion

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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